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# Tax Shelters: Economic Stimuli or Media of Inequality

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TAX SHELTERS: ECONOMIC STIMULI OR MEDIA OF INEQUALITY

BY

Charles M. Hull

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SECTION I

An Introduction To Tax Shelter Analysis

A. Toward History of Income Taxes.

Since the days of Pre-Socratic Philosophers such as Pythagoras and Heraclitus of Ephesus, man has tried to improve his social and economic lot. The thinking of those ancient scholars was directed toward one ultimate goal--that was to learn "What Is." These two words represented their search for truth in the social, scientific and religious environments. Over the centuries man has made constant gains in his search for truth in all of these areas--however, he still has a long road to traverse. From the early days of barter, society has paved its way by some form of economic system.

A popular legend has called Adam Smith the Father of Political economy. His two great books--The Theory of Moral Sentiments, first published in 1759, and An Inquiry Into the Nature and Causes of the Wealth of Nations, first published in 1776--are epoch-making in economic history as well as in the evolution of economic thought.

Another pioneer in socio-economics was Karl Marx. Marx and his colleague, Friedrich Engels, presented their thoughts and philosophies in the Communist Manifesto, published in 1848. Later, Marx elaborated his views in his Das Kapital. The above-mentioned authors were diametrically opposed as to their economic beliefs. Adam Smith purported that wealth was a product of specialization, while Marx held that wealth was a product of labor, and thereby belonged to the laboring class.

These two diverse philosophies have contributed to innumerable political and social revolutions over the years. Today, society is still tugging at the portals of knowledge in order to better refine the "What Is" in the environmental framework of economic thought.

The economic theories of Adam Smith were based upon the principle of laissez-faire, the let-alone principle, which represented a fundamentally uncontrolled productive and distributive market, driven by self-interest and coordinated by competition. He believed that the uninhibited operation of this principle would establish the market price at a competitive level in concert with the supply and demand for goods at a given point of equilibrium.

Unfortunately, or more appropriately fortunately, we do not live within the theoretical vacuum of Adam Smith's perfect competition. Other things come into play that create weights and balances against the operation or attainment of so-called "perfect competition." These consist of many factors, none the least are labor laws, anti-trust laws, and the whole spectrum of federal income taxes. This paper is directed toward the discussion of income taxes and their impact upon the socio-economic structure in which we live today.

Before delving into the complexities of federal income tax, tax shelters, and their impact upon the economy--be it positive or negative--it would seem proper to discuss the history of income taxes from early European times to the present day.

The income tax played, with rare exceptions, an insignificant role in the Middle Ages. For a long period of time taxation was of minor importance when compared with other sources of public revenue. Income was derived largely from the lucrative prerogatives of the feudal lord. When taxation did develop, it consisted largely of assessments



on various types of trade and transportation; when direct taxation began it took the form of a general property tax. (14, 41)

It is pertinent to recall some points in the history of the property tax so far as they have bearing upon the present discussion. First, under the feudal system real estate was rarely bought and sold--the only practical method of ascertaining the value of the land was by accounting for its rents. As it pertained to real estate, the earliest tax was assessed on produce rather than on sales value. When taxing methods became more sophisticated, the tax was assessed on the sales value of the land, such value being determined by the capitalization of the rents. Secondly, all movables or items of personal property were assessed at the sales level so that the tax became a combination of a tax on produce and on selling value. In the third place, salaries and wages were considered to possess some taxable ability, even if the taxpayer had no property. As the result of this, we frequently find an assessment on individuals in some proportion to their gains. This can be compared to the present-day policy of "net worthing" when an accurate accounting cannot be determined as a basis of taxation. No important professions existed for a long period of time during the Middle Ages. This meant that the day laborer bore the blunt of the tax. As for the salaries of state officials, the same methods were often followed as in the case of real estate--such salaries were reduced to a capital sum for tax purposes. Finally, as commerce developed and the gains of the businessman could not be approximated from invested capital, we often find a tax assessed upon the assumed profits of his business in the form of an income tax. (14,41)

In summary, the medieval tax system was little more than a general property tax. The greatest amount of revenue came from the taxation

of personal property and real estate; however, this was occasionally supplemented by a tax on the faculties of the laboring class and on the assumed faculties of the businessman. On occasion we find, in addition to the general property tax and at times a part of it, a personal tax. This was either in the form of a poll or capitation tax, which was designed to assess certain classes whose gains were not entirely in proportion to their property. (14, 42)

The taxing policies of England had no small impact upon the tax structures as they were developed in early America. In view of their importance in this area, it seems advisable to discuss some of these policies in brief.

After France declared war against England in 1793, new tax laws were enacted, and additional taxes were laid from year to year. Revisions were made to customs, excises, and stamp duties. Certain new duties were imposed on tea, stone, salt, and on collateral succession. Some assessed taxes had been increased by 10 percent in 1796, and again in 1797. The taxable property was extended from carriages, servants, and horses to include hairpowder, dogs, watches, and clocks. (14, 60-61)

These changes proved to be inadequate to cover the expenses of the conflict, and the French victories had an adverse effect upon British credit. By 1796 the situation had reached such alarming proportions that the national leaders were driven to numerous and varied schemes for fiscal stability. Although there had been an increase in the assessed taxes, most of the revenue came from expenditures rather than possessions. This led to a direct attack upon the wealth of the individuals by some direct assessment. One writer tried to bolster confidence by suggesting a "general and voluntary contribution." Bowles, a member

of Parliament, called it a "Public Contribution to be furnished by the general mass of proprietors"--he made it fairly plain that the yield was expected to come primarily from the wealthy class of people. The scheme was not adopted; however, a year later he stated that due to what he called the "inflexible obstinacy and increased malignity of the Opposition" funds were at their low ebb. (14, 60-61)

Another writer of the day, M.A. London, went so far as to advocate a progressive property tax. He stated, "Taxes should affect individuals in a progressive ratio, proportionate to their properties, for they who have the greatest interest at stake should bear the greatest charge." This same author was also willing to augment his proposed assessment by indirect taxes on luxuries. He stated they were the "properest objects for taxation in time of war." (14 61-62)

A work written in 1820 was designed to prove that "the present fiscal system compels the labourer, a dwarf in wealth, to carry the load of the lord, who is a giant in affluence." It implored the government to "express the taxes out of the accumulated wealth of the country, and not out of the blood and sinews and bones of a devoted and indefatigable people." (14, 117)

The British income tax, which was adopted May 31, 1842, went on trial during the years 1842-1862. It became the basis for future modifications of the British levy on income. Extreme opposition to taxes was evident from a statement of the day expressing the thought that, notwithstanding the reduction of expenditures as the result of a peacetime footing, the repeal of the former war-time income tax left a deficit in the revenues which necessitated the imposition of new taxes. Even prior to the above-mentioned period, resentment against taxes was at a



high point. The situation as it existed in 1820 was described by a writing in the "Edinburgh Review" of that same year. It described the tax load as consisting of assessments on food for eating, fuel for heating, light, and locomotion. There existed taxes on imports, exports, raw materials for manufacturing, drugs for medicinal purposes, textiles for clothing, toys for children, and finally a tax on a man's estate after he dies. (14, 117) The above statements could well be taken from the editorial page of a current issue of The Wall Street Journal.

The Act of 1842 was popularly called the Property and Income Tax Act. It was, for all intents and purposes, a reprint of the law of 1806. (14, 132)

The above discussion is not set forth to belabor the reader, but to emphasize the fact that the tax laws of England in the late 1700's and early 1800's were to some degree instrumental in determining the tax structure of early America.

#### B. Growth of Income Taxes in the United States.

With the exception of an early poll tax in Virginia, the first general tax law in the American colonies was the law of 1634 in Massachusetts Bay. The law provided for the assessment of each man "according to his estate and with consideration of all other his abilityes whatsoever." It is probable that the measure of this ability was to be found in property; for, although the law itself does not further explain the term, the matter is elucidated in a provision of the next year, that "all men shall be rated for their whole abilitie, wheresoever it lies." This seems to imply only visible property; for such property alone is susceptible of a situs.

Several years later "ability" was defined to include something more than property. This occurred in the colony of New Plymouth. In the year 1643 assessors were appointed to rate all the inhabitants of that

colony according to the estates or faculties, that is, according to goods, lands, improved faculties, and personal abilities. (14, 367-368) This law is noteworthy for two reasons, it is the first time the term "faculty" had been used, and it distinguished faculty and personal ability from visible property. Although it provided for a faculty tax, it did not tell us exactly how this faculty should be measured. This was reserved for a more comprehensive law enacted three years later by the Court of Assistants of the Massachusetts Bay Company. A court order of 1646 provided not only for the assessment of personal and real estates, but mentioned "laborers, artificers and handicraftsmen" as subject to taxation. It further provided that skilled persons in the arts and trades are more able to help bear the public burden than are the common laborers and workmen. ( 14, 368)

It is here for the first time that we observe a definition of "faculty" or "ability." The above sets out the faculty of the property owner in the produce of his estate versus that of "artists" and "tradesmen" in the returns and gains of their estates. The property value of an estate was approximately equal to the capitalized value of the yearly produce. In this manner the faculty of the property owner could be measured by the value of the property. Where no property existed, the assessors had to rely on "returns and gains." (14, 369-370)

The above-mentioned principle as laid down by the Massachusetts Bay colony was soon after adopted by other colonies. As an example, the colony of New Haven first levied a tax on land. In 1640 personal property was assessed by the provision that a new rate should be "estreeted, halfe upon estates, halfe upon lands." ( 14, 369-370) Later, laws in Connecticut, Plymouth, Rhode Island, and others were



patterned after the Massachusetts tax. (14, 369-370)

The Federal income tax, which might be considered the early forerunner of our present-day tax, has always aroused strong passions. During the Civil War it was reluctantly presented to Congress as a "disagreeable duty" forced by the threat of "the annihilation of this government." (6, 8)

On July 4, 1861 Secretary Chase suggested that a small portion—not to exceed \$20 million—of the required revenue be raised by means of direct taxes or internal duties or excises, or both. Following his suggestion, Stevens, the chairman of the Committee of Ways and Means introduced a bill providing for direct taxation and certain internal duties. It was estimated to provide revenue of \$30 million; the quotas expected from the loyal states being put at \$20 million. (14, 430-431)

In 1862 legislation was finally passed consisting of a comprehensive code of internal revenue taxes, of which the income duty formed only a part. A series of taxes were levied on the gross receipts of certain corporations, all railroads were required to withhold and to pay over to the government three percent on the interest of their bonds and dividends of their stock. All banks, trust companies, savings institutions, and insurance companies were to pay a duty of three percent on dividends, and on assessments added to their surplus or contingent funds. Salaries of government officials were taxed at the rate of three percent on income in excess of six-hundred dollars. (14, 437-438)

Wage earners of this modern day tend to think that the withholding of income taxes from their regular salary checks to be a comparatively new innovation. This is not the case. During the period of time under discussion, the technique of withholding was utilized.

Government disbursing officers and paymasters were required to withhold the tax at the time of the payment of the salary. The "income duty" property consisted of a tax of three percent upon "the annual gains, profits or incomes of any person residing in the United States, whether derived from any kind of property, rents, interest, dividend, salaries or from any profession, trade, employment or vocation carried on in the United States or elsewhere, or from any source whatever," if such income exceeded \$600. If the above-mentioned income exceeded \$10,000, the rate was fixed at five percent. Citizens living abroad were also taxed at the rate of five percent. Income from government bonds was assessed at the rate of one and one-half percent. In computing the annual gains, profits, or income subject to tax, deductions were allowed for all other national, state, and local taxes assessed upon the property or source of income, as well as for all incomes taxable under the sections of the law. (14, 437-438)

In summary, the Law of 1864 provided for income duty at five percent in excess of \$600 up to \$5,000; seven and one-half percent in excess of \$5,000 up to \$10,000, and 10 percent of amounts over \$10,000. Institutions such as banks, trust companies, savings banks, and insurance companies were taxed at five percent on their dividends and interest on bonds, the amount of such tax to be deducted from the sums due to the security holders. Sales were taxed at five percent of amounts over \$600. (14, 444)

There was considerable contest over the retention of the tax and after much debate in the House and Senate--the income tax was allowed to die a natural death and expired by limitation in 1872. (14, 444) For approximately two decades the income tax was not a serious political

issue. It is true that the Socialist Party and certain agrarian groups made demands for a progressive-type of income tax; however, the general prosperity of the nation during the eighties prevented these sectors from having a strong influence. (6, 8)

During the 1890's hard times descended upon the Western wheat farmers and Southern cotton planters. A conflict between the great industrial/financial centers with the West and South generated increased pressure for the income tax. Revenue of the individual states and local governments depended heavily on the property tax. These funds, of course, were coming from farmers and others in rural communities; whereas, the wealthy investors, the business community, and the professional people were bearing little of the tax burden. (6, 8-9)

The Democratic presidential victory of 1892 was in part a result of public sentiment against the above-mentioned tax inequalities and injustices. President Cleveland's proposal for an income tax in 1893 generated a storm of protests. Senator John Sherman stated: "In a republic like ours, where all men are equal, this attempt to array the rich against the poor or the poor against the rich is socialism, communism and devilism." (6, 9) Those who were in favor of the assessment were equally fervent in their drive for the measure. Congressman DeArmond of Missouri stated: "The passage of the bill will mark the dawn of a brighter day, with more sunshine, more of the songs of birds, more of that sweetest music, the laughter of children well fed, well clothed, well housed.... God hasten the era of equality in taxation and in opportunity." (6, 10) An income tax was levied at the rate of two percent on incomes over \$4,000; however, the predictions of neither Senator Sherman nor Congressman DeArmond were realized—the Supreme Court held the tax to be



unconstitutional. This declaration was made on the basis that the levy was a "direct" tax; such a tax could not be imposed under the Constitution without the provision for apportionment according to the population of the states. (6, 9) The Sixteenth Amendment to the Constitution, ratified in 1913, gave Congress the power to assess taxes on incomes from whatever source without apportionment among the several states, and without regard to any census or enumeration.

In retrospect the Civil War Income Tax had many shortcomings. It had mistakes of theory, the principle of stoppage-at-source was not widely used. Secondly, the law contained mistakes of principle and was confused in various of its parts. Thirdly, the exemptions were too high. The high exemptions, particularly those resulting from the amendment of 1870, not only curtailed revenue, but opened the door for evasion and fraud. Lastly, the administrative methods were inadequate. Table I gives a resume of collections for the years 1863 through 1877. (14, 476-481)

The income tax of 1894, which was the subject of much debate, was to be followed by the tax levy of 1913. The levy consisted of a one percent normal tax on all incomes above personal exemptions of \$4,000 for married persons and \$3,000 for single persons. A surtax began at one percent on incomes of \$20,000 to \$50,000 and rose to a top rate of six percent on incomes over \$500,000. (6, 11)

No great changes took place in the income tax structure until America entered World War I. Indeed, to a very large extent, military conflicts tell the story of the giant steps in our income tax. It was born in the Civil War, it first reached the levels of a steeply graduated levy in World War I and it was revolutionized in World War II. Heavy wartime budgets, inflation and expanded public services are at the roots

of the history of the income tax. (6, 11-12)

By the close of World War I, personal exemptions had been reduced to \$2,000 for married persons and family heads and to \$1,000 for single persons. Surtax rates had attained a high of 65 percent on incomes over \$100,000. In spite of this, a man with two dependents having an income of \$25,000 paid only \$2,850 in tax; and only five and one-half million returns were filed out of a population of 106 million people. (6, 11-12)

In 1921, a war-weary nation, which was experiencing declining production while the cost of living was still rising, elected Warren G. Harding to the White House along with a Republican Congress to back him. Andrew W. Mellon, considered by some people at the time as the greatest Secretary of the Treasury since Alexander Hamilton, immediately established a program to cut income taxes, particularly at the higher levels. By 1928, the top surtax rates had been reduced from a wartime high of 65 percent to 20 percent on incomes over \$100,000. At the same time exemptions for married taxpayers were increased to \$3,500, for a single person to \$1,500, with a \$400 exemption for each dependent. The reduction in the 1928 income tax is indicated by the fact that the tax on a family of four with a \$10,000 income had dwindled to \$83. (6, 12)

The depression of the thirties reduced budgetary surpluses of the twenties into deficits. The New Deal's measures to care for the unemployed and to broaden public services increased income taxes to some extent, while personal exemptions were decreased. (6, 12)

Events brought about by World War II, for the most part, revolutionized the income tax and set the stage for the concept as we know it today. For the first time in the history of the United States, the tax which had been an exclusively rich-man's liability, became a broad-based levy extending to the general masses of the population, coupled with steep

starting rates and rapid graduation to new highs. As an example of the aforementioned comments, seven and one-half million returns were filed in 1940 while the country's population stood at 132 million. (6, 13)

In 1960, 60 million returns were filed while the country's population was 180 million. In 1940 the rates started at four percent and rose to 79 percent. In 1962 they started at 20 percent and went to 91 percent. In 1940 a married man with two children paid a tax of \$75 on a \$5,000 income--in 1962 he paid \$520 on the same income. In 1940 the same individual paid a tax of \$3,570 on \$25,000 income while in 1962 the tax on the same amount of income amounted to \$6,300. At an income level of \$100,000 the 1942 tax rose from \$43,000 to \$52,000 in 1962. (6,13)

#### C. Necessity of Income Taxes and Problems of Incidence.

The necessity of income taxes and the problems of incidence are related to governmental regulation and the impact of such regulation upon the free business world in such a way that one cannot be discussed without the other. Government interference was discussed by Dunbar in a collection of Economic Essays published in 1904. He expressed his sentiments by drawing a parallel between the problems in international and domestic trade. He stated that in the discussion of domestic supply and demand and of price, it is assumed that the dealings are free from control or influence by any superior power; also, in the discussion of wages and profits, the competition of individual interest acts by itself. But plainly, the question whether competition may be restricted by law or by combination, or should be free, must be answered by independent reasoning. Dunbar reasoned that laissez faire is no part of the structure of the old economic doctrine. He strives to justify his sayings by



inquiring into the opinions as to particular cases of governmental action held by certain leading economists of the old school. He found among them a singular and often forgotten indifference to the doctrine so commonly associated with the system which they built up. He related the fact that Adam Smith sanctioned government interference in two test cases of the navigation acts and in certain cases of protective duties. To further his argument he recalled that Malthus supported the protective duties on British corn, further, Senior, dealing with the subject of distress among weavers and legislation for the relief of the poor, reached conclusions and made recommendations often entirely inconsistent with any idea of laissez faire. McCulloch, anxious to sustain the maxim pas trop gouverner, commended certain legislation regarding factory labor, on the homes of the poor, and on employers' liability. Mill was ever ready to suggest legislation as a cure for nearly every evil not considered positively incurable. In each of the above-mentioned cases the writer in question had no principle, as regards government interference, which could prevent his recommending it, if he considered the object aimed at important enough. To finalize his argument, Dunbar stated that Cairnes went so far as to declare expressly that "the maxim of laissez faire has no scientific basis whatever, but is at best a mere handy rule of practice, useful, perhaps, as a reminder to statesmen on which side the presumption lies in questions of industrial legislation, but totally destitute of all scientific authority." He finally quoted Cairnes as saying that we must never allow a rule to stand in the way of the consideration of any promising proposal of social or industrial reform. (3, 46-47)

Dunbar further discussed his philosophy of governmental interference, which by implication and association must include the whole realm of

income taxation by saying that the power of society is to be directed by a keen sense of duties, scientifically defined and recognized. Society is to consider things other than the mere enrichment of the community. It has a duty to the laborer in that he should be treated as something more than a tool of capital. Finally, he stated there can be no doubt that our sympathy with the aspirations of the laboring class as well as our zeal for those things that shall bring the masses of society to a higher level of existence in modern civilization, is and must always be altogether foreign to the questions as to the causes which determine wages. (3, 48-49)

The above quotations from the works of the learned Charles Dunbar, (published in 1904 by the late Professor of Political Economy in Harvard University) are reiterated here not to inject a complete new subject into this work, but to review the proposition that the results of governmental regulation, interference, etc., by legislative or other means are inherent within our society via the route of taxation--and very predominately by that type of assessment pertaining to the incomes of individuals and business enterprises, be such enterprises single proprietorships, partnerships, or corporations.

As we discuss the necessity of income taxes and their impact upon the society via the route of governmental regulations, controls, and restraints, so we must also discuss the incidence of these levies. If there is to be an ever-growing social structure, be it necessary or not, that is to a larger degree supported by assessments upon the incomes of its components, then inquiry must be made as to the equity of such assessments. As alluded to in the foregoing paragraphs, this question is one of long standing--alas, one that has haunted governmental entities--be they presidents, legislative bodies, dictators, emperors, and



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kings--for centuries. The Holy Scriptures give us some insight into the procedures of tax collection by the Roman Empire. The Roman administration collected taxes of various kinds from the inhabitants of Palestine. Water, meat, and salt were subject to taxation. There was also a road tax, a city tax, a house tax, as well as a poll tax. (Book of Mark, 2. 13-17)

In modern times the equity of taxation starts with the rate schedule and seems to wander ad infinitum through deductions, exemptions, etc. Hellerstein, writing on the subject of tax loopholes in 1963 has called the rate schedule the "Grand Delusion." He has stated: ".....the rate schedule is a colossal delusion. Our affluent taxpayers, as a rule, just don't pay taxes on their incomes at the high scheduled rates. And the reason is that our tax laws are full of leaks, loopholes, exemptions and preferences." If we consider the revenues from taxes that would be collected from upper-bracket taxpayers, if the rate schedule were actually applied to the incomes of our more affluent taxpayers, and then look at what they really pay, we would find the comparison highly illuminating. For the year 1956, the last year for which detailed studies are available, (at the time of that writing) the average income-tax liability of individuals with incomes of \$100,000 or more, amounted to approximately 36 percent of their incomes. Yet, the tax tables call for an effective rate of approximately 67 percent applied to \$100,000 income for an individual; at an income level of \$200,000 the effective rate would be about 78 percent, and at the \$ 500,000 level it would be 80 percent. (6, 16)

"The tax base has leaks in it. Some income is exempt from tax by law; some types of income are granted preferential rates of tax; and some classes of taxpayers are the beneficiaries of preferred rates.

Finally, deductions of a dubious character effectively reduce high incomes." (6, 17) In this vein Hellerstein goes further and mentions a few of these tax preferences, some of which will be discussed in more detail later in this study.

Hellerstein mentions tax-exempt municipal bonds. This exemption--on income from securities issued by a state or local government--was placed into the law in 1913 and has been there ever since. (6, 17) He also refers to the preference resulting from capital gains by saying: "The income-tax law is based on the principle that in order to produce equality of tax burden, we need inequality in tax rates; that as a man's income goes up, his ability to pay taxes increases, and rates ought to rise." (6, 18) Yet one of the deepest cuts in the actual tax liability of higher income taxpayers grows out of the reversal of this principle in the case of capital gains. Profits from the sales of stocks, bonds, real estate, and other properties are taxed at lower rates than income generally. Obviously, the upper and middle-bracket taxpayers own the largest portion of the property in the country; consequently, they generate the capital gains (and losses) by virtue of their holdings. A study based on net long-term capital gains (the excess of gains over losses) of \$3.7 billion reported in 1957 (only one-half the actual gain was required to be reported) estimates that \$1.4 billion of additional taxes would have been collected had these profits been taxed in the same manner as income generally. Treasury reports covering later years show that net long-term capital gains reached an all-time high of \$4.1 billion in 1959 and dropped to \$3.8 billion in 1960. (6, 18)

The above comments by Hellerstein alluded to the problems associated with the incidence of the tax. There is an enormous concentration of

corporate income in a small fraction of American corporations. In 1959 1,074,000 corporate income tax returns were filed. Only 670,000 of such returns reflected any taxable income, while the remaining 404,000 (40 percent) of all the corporations, reported deficits. There were 600 large corporations with net incomes of \$10 million or more, which accounted for about \$26 billion of corporate net income--over one-half the net income of all corporations in the country. (6, 58-59)

This then brings the problem of tax incidence clearly into focus. Speaking of the corporate income tax--the question is who really bears the burden? In recent years there has been a growing belief among economists that most, possibly nearly all, of the corporate income tax is shifted to consumers in the form of higher prices. The most persuasive evidence of this shifting is provided by studies showing that, despite rising corporate income taxes during the last thirty-five years, corporations have still had about the same rate of return on their book net worth, after taxes. Between 1920 and 1955, the corporate income tax rates quadrupled; they rose from 12-1/2 to 52 percent; however, the after tax earnings on book net worth remained about the same, namely, 12 percent in 1920 and 13 percent for the years 1952 to 1955. If we consider all manufacturing corporations, the 1920 after-tax returns amounted to eight percent, and for the years 1952 to 1955, the rate was eight and one-half percent. (6, 58-59)

The corporate income tax is second to the personal income tax as a revenue producer. During the year 1962, it accounted for \$21.3 billion, as compared with \$50.6 billion for the individual income tax. (6, 58)

The Federal income-tax structure provides that corporations be taxed as separate legal entities and that stockholders be taxed on the



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dividends they receive from such earnings thereby declared. This double taxation of the corporations, once to the corporate entity and again to the stockholder, is unique in the tax law. The business income of individual proprietorships and partnerships is taxed only once--to the owners of the business; there is no income tax on business enterprises, as such, in the tax law. In like manner, wages, royalties, interest and rents are taxed just once. There has been widespread pressure for the elimination or the relaxation of the double tax on corporate profits. This explains the exemption from tax of the first \$50 of dividends and a reduction of the tax rate on dividends by four percentage points below the taxpayer's usual rate.

James C. Carter, a noted lawyer and past president of the American Bar Association, has been quoted as saying: "In every community, those who feel the burdens of taxation are naturally prone to relieve themselves from their fiscal discomfort. One class struggles to throw the burden off its shoulders. If they succeed, of course it must fall upon others. They also, in their turn, labor to get rid of it, and finally the load falls upon those who will not, or cannot, make a successful effort for relief." (4, 4) Carter ungraciously added that the "struggle" is a one-sided affair, "in which the rich only engage and in which the poor always go to the wall." (4, 4)

Eisenstein, writing in 1961 on the subject of progressive taxes, stated that although ideologies invoke lofty abstractions, they are sensitively adapted to practical needs. Within the realm of our fiscal system today these needs are the progressive income tax and the progressive estate tax. The above have a direct bearing on the incidence of such taxes. Both of these types of assessments have changed

significantly over the years; however, one basic question has remained with us. How are progressive taxes to be reconciled with an economic system which places a premium upon private initiative and the accumulation of wealth? Such a system presupposes that businesses and individuals should be busily engaged in adding to their inventory of worldly goods; however, a progressive tax also presupposes that as the above-mentioned recipients of tax levies make more and more, they would keep a lesser and lesser proration of the gain. (4, 12)

This controversy within our economic environment has spawned various ideologies, all of which have been pursued with great diligence. More importantly, it has spawned an economic illness within the taxpaying entities, be they individuals or corporation, which might be described as a creeping schizophrenia.

The argument can be pursued from many facets. One advocate, Eisenstein stated: "Progressive taxes dangerously diminish the desire to work; they fatally discourage the incentive to invest; and they irreparably impair the sources of new capital. Our economic system must come to an untimely end if private capital cannot accumulate and private initiative is destroyed." (4, 13) He further exemplified the situation by his very sharp remark to the effect: "...the adherents of one ideology may skillfully borrow the language of another in order to be more persuasive. In tax law, too, the devil knows how to quote Scripture with a display of conviction." (4, 14)

If we choose to profit from history, we may remind ourselves that originally, the principle of ability to pay went hand in hand with proportional taxation--the same single rate on all incomes. Adam Smith summarized this when he enunciated his famous maxims of taxation. The first of these was equality of burden. Smith stated that the subjects

of every state have an obligation to contribute towards the support of the government in proportion to the respective abilities, that is, as nearly as possible in proportion to the revenue which they respectively enjoy while under the protection of the state. (4, 26-27)

John Stuart Mill condemned the progressive tax as "a mild form of robbery." Eisenstein states that not even Adam Smith was entirely faithful to the principle of equality as he understood it. After arguing that taxes should be proportioned to incomes, Smith remarked, "It is not very unreasonable that the rich should contribute to the public expence, not only in proportion to their revenue but something more than in that proportion." (4, 28)

Andrew Mellon opined that the prosperity of the middle and lower classes depended upon the good fortunes and light tax burden of the rich. (4, 63) The reasoning here, obviously, is that if their taxes were too high they would retrench in the areas of investments--such action thereby being detrimental to the economy.

#### D. On The Tax Reform Issues.

Generally speaking, all reform aims have been pointed in the direction of closing so-called "loopholes" through which it is alleged that much income escapes bearing its proper share of the overall tax burden. Over the past fifteen years repeated attempts have been made at reformation; however, these have not really been successful in eliminating the most frequently cited "loopholes." Chairman of the House Ways and Means Committee, Wilbur Mills, introduced a bill (H.R. 15230) calling for the repeal over a three-year period of 54 provisions often referred to as tax shelters or loopholes. Senate Majority Leader Mansfield submitted a companion bill (S. 3657) in the Senate. The intent of the bills'



sponsors was not to have all or even most of these provisions permanently taken off the books, but to have them repealed in a systematic manner extending into 1974, 1975, and 1976. (5, 1-2)

The question may be asked--why tax reform? Is there a real need for reform? If so, should such reform take on the aspects of the elimination of many, or as many as possible, of the above-mentioned loopholes; or, should these loopholes--more appropriately called tax shelters, be redirected in such a way that they would generate a boost to the economy by effecting a higher level of investment in machinery and equipment, additional spending for consumptive goods by the individual taxpayer, or such other means that would not only increase production, but also give the public the ways and means of consuming additional production. Some empirical data relating to the above questions is enumerated in the following comments.

The Federal income tax now reaches only about one-half of all personal income as spelled out in the national income accounts. Even the taxed one-half is not always subjected to the full impact of the tax schedule. Some critics of the status quo wonder whether it makes "equal justice under the law" to levy rates rising from 14 percent to 70 percent on one-half of all income when at the same time a flat rate of 10 percent on all personal income, or a 14 percent rate on "adjusted gross income" would yield about the same revenue. (5, 2)

Much of the complexity in the Internal Revenue Code, which over the years has progressed from intricacy to near incomprehensibility is the result of the following:

1. The expansion of the law by too many exclusions, exemptions, deductions, and other means that trim down what we call "taxable income."

2. Differential rates imposed on different types or magnitudes of income.

For years, Congressional committees--House Ways and Means, Senate Finance, Joint Economic, Joint Internal Revenue Taxation--have conducted tax reform hearings; however, after tens of thousands of pages of testimony few tangible results have developed. (5, 12)

Freeman stated: "The fact is that the tax code has grown more complicated every time Congress has attempted to improve it--most recently so with the Tax Reform Act of 1969 which is widely, and justifiably, called the Lawyers' and Accountants' Full Employment Act of 1969." (5,3) He further stated that virtually all provisions that protect some income from the full impact of the rate schedule--or for that matter any tax--were put there not by inadvertence, ignorance, or for the purpose of giving some favored groups improper advantage or privileges. Most of the tax differentials aim at one or both of the following objectives:

1. To provide greater equity, horizontal or vertical, among taxpayers and different types and magnitudes of income by considering different circumstances and offering relief for hardships.
2. To provide incentives whereby taxpayers may be motivated to enlarge their activities which add to the public good. This is accomplished by rewarding some and imposing penalties on others.

These two objectives often produce conflicting results when translated into tax policy. (5, 3-4)

If it were only a matter of resolving material conflicts, tax problems would not be so difficult to resolve; however, it is not all that simple. Certainly, it is not unusual for the controversies to center around fundamental principles of equity in the distribution of income--or public policies that compound the complication. Our lawmakers



strive for equality and neutrality—however, neutrality is almost impossible in today's political environment. During the early part of the twentieth century, the tax bite was approximately 10 to 15 percent of the nation's income. In such a tax environment, policies of neutrality are at least theoretically, and maybe politically, feasible; however, today, with those percentages reaching 40 percent and higher—the Federal Government cannot leave all individuals in the same relative position after taxes as before. Freeman states: "An even harder division to resolve is the ideological conflict over the government's role in the economy." He opined that some believe that the rewards and punishments of the market place are, by and large, merited and fair. Not only is this true, but the highest economic growth is produced by giving market forces the widest possible free rein. In order to insure the greatest good for the greatest number of people over the longest period of time, then, this fact would wish to leave pre-tax relative positions as undisturbed as possible. In spite of this, many advocates of such a free market policy concede that government may need to provide remedies and relief for the economic casualties—whether such casualties result from impartial forces, the activities of more efficacious groups, or management's own fault. (5, 5)

Accordingly, the view has become prevalent that it is government's prime responsibility to correct the imperfections of the market place—to alter through political processes the rewards and punishments of the free operation of the market forces. In some quarters it has become commonplace to regard government chiefly as a huge device for the redistribution of income from those who have more to those who have less regardless of what reasons might underlie an individual's poor economic condition. (5, 6)

By and large, redistribution of income by means of progressive taxation and public expenditures has become so generally accepted in the United States as well as other countries of the world that the principle as a rule of public policy is no longer seriously questioned. There is, however, one question that has not been answered. How far should any government go in taking a larger slice from those who produce and earn, and in giving to those who produce less or nothing. Where is the point at which incentives are weakened? Should the tax structure be made more progressive than it is, or less? Most arguments over tax issues, most battle lines are drawn, and most decisions are arrived at by the criterion of redistribution of income. (5, 6)

One of the most knowledgeable advocates of "loophole closing" was Professor Stanley S. Surrey of the Harvard Law School. He was appointed Assistant Secretary of the Treasury for Tax Policy in 1961. Although he spent almost eight years in efforts directed toward tax reform, very few of his recommendations were put into practice. Surrey theorized that most of the tax deductions, exclusions, exemptions, and credits are the equivalent of public expenditures and ought to be treated as such and subjected to the same type of annual review by Congress and the executive branch as any other expenditures. He prepared an estimated "Tax Expenditures Budget" which placed the total between \$42 and \$45 billion for fiscal year 1968. In 1972 he estimated that government expenditures would be from \$55 to \$60 billion a year through tax concessions. (5, 9-10)

The question of tax shelters always brings up the point that the rich get an advantage over the poor. This subject has been debated for decades and is always good fuel for political fire. The event that started the tax reform drive in 1969, was then Treasury Secretary Joseph Barr's

statement before the Joint Economic Committee just two days before relinquishing office. Barr stated: "We face now the possibility of a taxpayer revolt if we do not soon make major reforms in our income taxes. The revolt will come not from the poor but from the tens of millions of middle-class families and individuals with incomes of \$7,000 to \$20,000, whose tax payments now generally are based on the full ordinary rates and who pay over one-half of our individual income taxes. The middle classes are likely to revolt against income taxes not because certain provisions of the levy or amount of the taxes they must pay but because certain provisions of the tax laws unfairly lighten the burdens of others who can afford to pay. People are concerned and indeed angered about the high-income recipients who pay little or no Federal income taxes. For example, the extreme cases are 155 tax returns in 1967 with adjusted gross incomes above \$200,000 on which no Federal income taxes were paid, including 21 with incomes above \$1,000,000." (5, 19)

Roger A. Freeman states there is no evidence that the middle class of taxpayers actually bear a disproportionate share of the tax burden as Barr had alleged. Table II asserts to the contrary.

The Tax Reform Act of 1969 was the first sincere attempt to face the problem of tax reform that had been advocated for approximately fifteen years. It was a cautious step--it did not go far and did not really face the difficult issues at hand. Among other things, the Act reduced gas and oil depletion allowance from 27.5 percent to 22 percent, tightened the availability of the 25 percent capital gains, established a minimum tax on income with limited tax preferences (LTP) and imposed a 4 percent tax on the net investment income of tax-exempt foundations. These provisions were dwarfed by the tax reductions granted by the Act.



The following is an example of such provisions:

1. Personal exemptions were increased to \$750.
2. An increase in the standard deduction to 15 percent with a maximum of \$2,000. (From 10 percent and \$1,000)
3. Reduction from 70 percent to 50 percent in the top rate on earned income and a maximum tax for single persons that cannot exceed 120 percent of the amount they would pay if they were married.

On the overall, the tax liability of returns in the lowest income bracket was cut by 70 percent, that of returns in the highest bracket raised by 7 percent. In excess of nine million persons were dropped from the tax rolls altogether. ( 5, 12-13)

Although it was announced as an attempt to broaden the tax base, the Tax Reform Act of 1969 increased the percentage of personal income that is not normally reached by the Federal income tax by two percentage points--from 48.2 percent in 1969 to 50.2 percent in 1970. In December 1971 another bill was enacted by Congress that consisted almost wholly of tax reductions. Not only did it accelerate some of the relief provisions in the 1969 Act but added other remedial provisions. The 1971 measure allowed credit for political contributions for the first time; widened child care deductions; introduced the 7 percent investment credit. It must be noted at this point, that revenue losses resulting from the 1969 and 1971 Acts have contributed to no small degree to recent budgetary deficits. The unified budget deficit ran between \$23 and \$25 billion in the fiscal years 1971 and 1972. All signs point to the fact that deficits are becoming a permanent feature of our fiscal system. ( 5, 13)

Spokesmen for the tax reform drive continue to point out large dollar amounts that are being lost year after year to tax concessions. Ways and Means Chairman Mills referred to tax concessions as "a form of backdoor spending." ( 5, 13)

Now let us delve into some of the specifics of tax reform. The fire of tax reformation never burns out, although at times it seems to die down to mere burning embers. It can always be fanned into a roaring inferno by politicians, certain quarters of business, pressure groups, or just plain do-gooders. The philosophy of tax reform for the sake of income redistribution makes a much better slogan than a working program. Although reforms can point to existing inequalities in income distribution, they almost universally ignore the undeniable progress in real per capita income gains that have been made by all income groups over the post-war period. Although it is now fashionable to downgrade economic growth, we must realize that such growth has contributed greatly to our standard of living. ( 11, 3)

The reformers have not attempted to answer, nor are they sure what would happen to our socio-economic system if a forced large-scale income redistribution is effected through the tax system. This revolutionary change could effect work incentives, the market processes, and the general overall standard of living. The cold facts are the real wealth of any industrial country does not lie in the static distribution of income but in the dynamic process of production. Before completely revolutionizing the tax system in order to bring about a social change, the Congress and the nation should address themselves to the question of what such change would do for the production processes--incentives to work--and not the least important--incentives to invest.

If we are to embark upon a voyage of "loophole closing" to raise additional revenues in order to finance existing government programs--or to institute new ones--we must look at the effect of such action in the cold light of economic realities. Arthur Okun has stated that loophole plugging is "more virtue than revenue." (11, 3)



As mentioned previously, the project of loophole closing makes for good political fodder; however, there are many specific problems. In 1972 the National Association of Manufacturers of the United States published a position paper written by the Committee on Taxation of that organization. The following are some specific comments from that paper:

1. Claims that revenue lost through loopholes would be available by the elimination of "cost" attributed to these provisions is absolutely not true. The undeniable fact is that individuals and industries would not invest in the exact same manner after such tax changes as they did before.
2. Many of the tax preferences that are, and have been, the targets of reforms--such as capital gains--have been a part of the Code for decades. In many cases the assets have been capitalized long beforehand. Also, along with traditional bias against ex-post-facto legislation--it seems very likely that any tax reforms have to be applied prospectively and would have to be phased in gradually over a number of years.
3. Many of the tax preferences in terms of "cost" are enjoyed by the great mass of middle-class taxpayers. Can we remove the deduction for interest payments without a compensating government subsidy? Is this an equitable adjustment? Another thing that we must look at realistically--the revenue cost of tax loopholes enjoyed by upper-income groups are not really all that big due to the fact there are so few individuals in that category.
4. If tax preferences applicable to the investment sector--particularly the investment credit are eliminated--again without compensating rate adjustments--would not the economy slow down and revenues otherwise derived from good profit and income performance be lost? (11, 3)

When we quantify the various provisions, we then begin to look objectively into the results of plugging tax loopholes. We might consider the Joint Economic Committee's compilation of the gross budget cost of so-called major tax subsidies for 1971--estimated that by eliminating the whole list would probably produce in effect only about a quarter of that amount (\$8.95 billion) in the initial years. We must ask the question as to what impact that would have upon the fiscal budget of 1973

of \$250 billion, and a budget deficit nearing \$30 billion?

Those who would replace tax incentives with direct government expenditures ignore the cost of the new spending programs; however, it must be admitted that such a procedure might be a better vote-getter. (10,3) Where is the additional revenue coming from? As mentioned previously, the Joint Economic Committee staff recognizes that tax revenues reputedly "lost" because of present tax law provisions assumes that all of the "cost" attributed to these provisions would be available as revenue if such laws were changed. This is not exactly true.

As an example of the above--the investment credit is available only to those who purchase capital goods. It is agreed that the absence of such credit would not eliminate capital investment but certainly would restrict it where the taxpayer has a choice. The exemption of interest on state and local bonds is a tax preference only to those who invest in such securities, and only to the extent they forego higher yields on alternative taxable investments. If tax preferences were removed there is no reason to believe that the amounts invested this way would remain the same. (11, 12-13)

In the case of capital gains provisions--if that preference were removed it might well be that less taxable income would be generated than is now the case. With very few exceptions, one can run the gamut of so-called tax-preferences and see that the pattern of economic behavior--whether it be personal or corporate--would not remain the same if a change in the pattern of tax practices as proposed by the "loophole closers" were made. (11, 12-13)

The position papers published by the NAM (National Association of Manufacturers) referred to above, discusses a survey conducted by the



Bureau of Economic Analysis of the Department of Commerce in April and May 1972. Business expected to spend \$89.6 billion on new plant and equipment during the year 1972. This amounted to a 10.3 percent increase over 1971 spending (compared with an increase of 1.9 percent over the previous year.) If tax preferences, particularly the investment credit and ADR (Asset Depreciation Range), are eliminated without compensating rate adjustments, (and this factor is important) the economy itself will slow down and revenues that are otherwise derived from profit and income performance will be lost.

Again, it makes for popular politics to expound upon the virtues of tax reduction for individuals by "tightening up on business;" however, there is more here than meets the eye. It has been proposed by some authorities that this proposition misses the point altogether. They state that business taxes are borne by individuals in the final analysis. By increasing the business tax burden, a drain would be created upon wages, rents, dividends, and the creation of new jobs, not to speak of jeopardizing future revenue growth. (11, 16)

In a statement made to the Joint Economic Committee in July 1972, Under Secretary of the Treasury Cohen presented estimates by income classes of the distribution of the burden of the corporate tax based on five different assumptions as to the extent of the division between consumers and shareholders. (10, 16) These data are presented in Table III. If we assume that consumers bear no portion of the corporate tax burden, but shareholders bear all of it, almost 25 percent falls on A.G.I. (Adjusted Gross Income) groups under \$10,000 and almost 30 percent on those up to \$15,000. Effectively, this amounts to taxpayers in the lower brackets of the Adjusted Gross Income scale having to bear an undue



portion of the business tax burden by virtue of the corporate sector being denied tax preferences.

The combined effect of the 1969 and 1971 Acts, according to U.S. Treasury information, is an increase in corporate income taxes of almost \$5 billion for the years 1969 to 1972. It is true that corporations will get significant relief in the future as a result of the 1971 Act, but the same data show that by 1980 benefits to individual taxpayers would be seventeen times greater than those of corporations from the two major bills. These comparisons are shown in Table IV. (11, 19)

As a conclusion of the position paper of the National Association of Manufacturers: "Charges of tax favoritism for large business over small-- implying that the large pay lower effective income tax rates--simply do not stand up. While it is easy to show widely differing tax burdens between individual corporations for a variety of reasons but mainly because of uneven profit performance and loss carry-forwards--the effective rate of corporate income taxation for major corporations with assets over \$250 million is virtually the same as for the corporate sector as a whole." (11, 19)

Table V shows effective rates by asset size for all active corporations and for those with net income. If we just look at net income-- sometimes this is a better method for measuring effective rates--the large corporations paid a somewhat higher effective rate of tax.

## SECTION II

## Tax Shelters

The previous discussions covering the history of taxes in general, the pros and cons of government intervention in private enterprise, as well as various types of tax shelters, hopefully will serve to set the parameters for the following comments concerning specific accounting functions that contribute directly or indirectly to tax relief in business.

A. Investment Tax Credit.

This provision was enacted in 1962 as a long-term plan to help move the economy forward by allowing a 7 percent credit on machinery and equipment. It was suspended from 1966-1967 and repealed in 1969 on the basis that it was contributing to inflation. The provision was re-enacted in 1971 at a 7 percent level. The amount of credit varies with the useful life of the asset and the full 7 percent applies only if the property is held for seven years or more. Assets ordered on or after April 1, 1971, or acquired after August 15, 1971, are eligible. (11, 26)

The 1971 re-enactment is considered a reduction of the bias in the tax structure against capital formation and investment in producers' durables. It also assists in replacing, for investment purposes, funds that are being diverted to meet pollution control requirements. In the final analysis, in combination with realistic depreciation practice, it helps to place U.S. firms on a more competitive level with foreign producers who benefit from certain incentive provisions generally used in other industrialized countries. National Association of Manufacturers'

representatives have emphasized the importance of the permanency of the credit in order that long-range commitments and planning can anticipate consistent tax treatment. According to the National Association of Manufacturers, the revenue cost per preliminary Treasury estimates amounted to \$1.8 billion in 1971, \$3.6 billion in 1972 and \$3.9 billion in 1973. This assumes a 5 percent investment growth and does not reflect the "feedback" effect. (11, 26)

In consideration of the Revenue Act of 1971, there is still evidence of the bias against capital formation in the tax structure. The following data listed on Table VI shows 1971 estimates of the aggregate cost recovery allowances for the United States--with Asset Depreciation Range and the 7 percent investment credit--relative to those of eleven other leading industrial countries. The above-mentioned data, represented by Table VI, states the United States position is improved; however, it still remains less favorable than the average of this foreign competition. The aggregate cost recovery allowances (percentage of cost of asset) for the first taxable year shows the United States average to be 28.3 percent versus 25.7 percent for the foreign countries; however, for the first three taxable years and the first seven taxable years, the related averages are 57.8 percent and 90.5 percent for the United States versus 58.3 percent and 91.3 percent for the foreign countries. It might be noted that the data shown in the above-referenced table does not reflect changes in the United Kingdom after October, 1970. In addition, the data overstates the United States percentages somewhat because effect of the modified first-year convention, disallowed by the Revenue Act of 1971, is included. The data also assumes double-declining method of depreciation and a change to straight-line in the seventh year. (11, 22)



In 1962 Secretary of the Treasury Dillon argued for the dual approach of modernization of depreciation guidelines and for implementation of the original investment credit in order to place the United States on a better footing vis-a-vis for competition. After ten years of rapid technological change coupled with increased economic obsolescence of productive facilities, and at first a gradual, then precipitously declining trade balance, this argument bears more and more consideration.

(11, 22-23)

Another reason for a more effective cost recovery system is that the rules of the game concerning air and water pollution have changed drastically over the last ten years. Industry must spend billions of dollars to comply with new air and water quality standards--these are becoming more rigid as time goes by. It should be obvious that it is much more difficult now to finance new machinery and equipment to increase production while at the same time meet these new control commitments. (11, 23)

Chart 1 shows graphically the combined effect of increased capital consumption allowances relative to after-tax rates of return for assets with ten-, fifteen-, and twenty-year services, assuming that the assets yield 10 percent on a straight-line depreciation basis. The combined effect is noticeable in all three cases. The rate of return is increased by double-declining depreciation and a 7 percent investment credit to 12.5 percent for a ten-year asset, 12 percent for a fifteen-year asset, and 11.7 percent for a twenty-year asset. The referenced data states the investment credit provision accounts for approximately 60 percent of the increase in rates of return.

The investment credit provision encountered resistance before it

was finally enacted into law. This opposition came not only from businessmen who were not benefiting from the law, but also from those who were. Although many opposed the credit on the grounds of equity, few denied its effectiveness as a method of stimulating investment. (12,129)

The investment credit provision was suspended during the period October 10, 1966, through March 9, 1967, in order to counteract the inflationary pressures that developed during the early part of the Vietnam War. As the inflation trend continued at a high rate, the credit was repealed effective April 19, 1969. (12,129) It is true, substantive criticism can be leveled at the credit. Unlike other reductions in rates that would benefit all industry, this provision favored capital-intensive industry. Experience with the original credit showed its use to be widespread; further, it was highly successful in encouraging investment, employment and in increasing productivity. During the period 1962 through 1969 output per man-hour in the manufacturing sector rose more than 3 percent per year, while employment increased by 3.2 million.

Floyd G. Lawrence, Executive Editor of Industry Week, has suggested a more "activist" role for industry. He has stated that the time has past for industry to plead for peanuts. It is no longer sufficient to take their hat in hand and beg politicians not to turn the on-again investment tax credit off again. Instead, industry should insist the credit be retained as a growth stimulus which will produce revenues and also demand evidence to show why it should not be 15 or 20 percent rather than 7 percent. It is no longer enough merely to accept depreciation "reform." Industry should demand fundamental and sweeping changes in allowances which understate replacement costs and overstate profits by approximately \$10 billion each year. (11, 23)



## B. Foreign Tax Credit Provisions.

From the beginning in 1913, U. S. citizens, residents, and corporations have been taxable world-wide on all their income regardless from what geographical sources derived and foreign losses have been deductible. Further, a foreign corporation traditionally has been treated as a separate entity, except after 1937 in the tax avoidance case of a foreign personal holding company. To eliminate what was labeled as confiscatory double taxation, Congress in 1918 enacted the foreign tax credit provisions. This credit at first allowed all foreign income taxes to offset the U. S. tax liability on a dollar-for-dollar basis. By 1921, evidence proved that the foreign tax credit was going beyond the basis purpose of the elimination of double taxation. Because of the unlimited amount of the credit, foreign taxes could and did offset U. S. taxes on U. S. incomes. As the result of this, in 1921 two limitations were added to the law--the overall limitations and the corporation-by-corporation limitations. In general, these limitations confined the credit to an offset only against U. S. taxes on foreign income. In the year 1932 Congress adopted the country-by-country limitation. This prevented foreign income taxes paid to one country from offsetting U. S. taxes on income derived from another country. After 1932 the foreign tax provisions were many times the subject of Congressional scrutiny; however, all pre-1962 changes were directed toward more liberal allowances. In 1942 certain foreign excise taxes were brought within these provisions and also taxes paid by a second-tier foreign subsidiary were permitted to be credited at the time their earnings found their way to the domestic parent corporation. In 1943, the corporation-by-corporation limitation was removed. In 1942, due to complaints by certain corporations operating in



Latin America, the Western Hemisphere Trade Corporation provisions were adopted. A surtax exemption was allowed corporations doing all of their business in the Western Hemisphere and engaging in the active conduct of business. (I, 228-230)

For the period 1950-1961 certain changes were made. Three Liberalizing modifications were enacted into law in the Revenue Act of 1951:

1. Exemption of foreign earned income was extended to U.S. citizens who could not qualify as residents of a foreign country; however, they were abroad 17 out of 18 months.
2. To effect minimization of death taxes for estates with foreign investments, a foreign estate tax credit was enacted.
3. Stock ownership requirements were reduced for permitting foreign taxes of first-and second-tier subsidiary corporations to qualify for foreign tax credits. (I, 230-231)

In 1961, President Kennedy designed heavier tax burdens on overseas operations of American business--mainly due to the fact that reasons no longer existed for investing in developed countries. The Revenue Act of 1962 changed the historic pattern for taxation of income from foreign operations.

1. Undistributed "tax-haven" income of controlled foreign corporations was subjected to current taxation to United States shareholders.
2. The foreign tax credit allowed for foreign taxes of foreign subsidiaries operating in developed countries was required to be "grossed-up."
3. The earned income exemption of United States citizens was reduced considerably.
4. Earnings of foreign corporations were taxed as ordinary income in case of liquidations and sales of stock of such corporations.
5. A separate limitation was added to the foreign tax credit for passive interest received from foreign countries. (I, 239)

### C. Capital Gains Provisions

The question often arises as to what constitutes capital assets.

They may be identified as all assets excluding the following:

1. Stock in trade or other inventory property.
2. Property held primarily for sale to customers in the ordinary course of business.
3. Depreciable or real property used in a trade or business.
4. The normal notes or accounts receivable derived from the sale of goods or services.
5. A copyright, a literary, musical, or artistic composition, a letter of memorandum or similar property in the hands of the author, composer, or someone whose basis is determined by reference to the author.
6. Governmental non-interest-bearing discount obligations maturing in one year or less.

There are certain types of assets that do not qualify as "capital assets" that may produce capital gains upon their sale or exchange; however, for purposes of this paper they are not enumerated here. (13, 164)

Of all tax avoidance (this nomenclature is used as opposed to tax evasion) loopholes, none is referred to more often as an example of the tax system's unfairness than taxation of long-term capital gains at half the normal income tax rate. (5, 41)

The statement has been made by First National City Bank of New York: "It is seen by some as a nefarious device by which the rich avoid paying very high rates on top-bracket incomes, the Treasury loses billions in revenues, and the progressivity of the income tax is weakened." Ways and Means Committee Chairman Wilbur Mills said in the spring of 1972: "It is pretty hard to justify treating a capital gain differently from ordinary income. I've never felt there is anything more sacrosanct about the profit from the sales of an asset than from the sweat of your brow."

Senator McGovern remarked: "Money made by money should be taxed the same rate as money made by men." ( 5, 41)

There are just as many arguments as to why realized gains should not be taxed as ordinary income. Some of these are listed as follows:

1. Assets held for a number of years, or even for a decade, may have increased in price, if for no other reason---inflation.
2. Consumer prices have increased 25 percent during the past five years, 40 percent in the past ten, and almost 100 percent during the last 25 years. If such a gain were taxed it would amount to a capital levy, not just a tax on income. ( 5, 43)

Dan Throop Smith, a tax policy expert who served as deputy to the Secretary of the Treasury during the Eisenhower administration, wrote the following opinion: "It is hard to imagine any single change in the tax law which would do as much damage to economic development as the full taxation of capital gains, even if the maximum rate were reduced to 50 percent. The risk of loss is so great in so many important areas of investment that anything like a half-and-half sharing with the government would seriously curtail investment..." Smith stated that the effects of a tax on capital gains are amplified because there are no non-pecuniary incentives for investment. (5, 46)

Another observer stated: "First, risk-taking incentives and the supply of essential venture capital would be seriously curtailed. Second, investments in modern plant equipment and in new technologies would diminish. Third, the mobility of capital assets--which is crucial to maintaining a dynamic and fluid economy--would be impeded." (5, 46-47)

For the above-mentioned reasons no industrial nation taxes capital gains as ordinary income--some of the countries with the most rapid economic growth--such as Germany and Japan--do not tax them at all. This



is done in an effort to stimulate capital formation and growth; to introduce new products and methods as well as expand employment. (5, 47)

D. Allowances for Depreciation.

In 1947, United States Steel Corporation engaged in a battle of depreciation ideologies by computing depreciation, for financial statement purposes, on the basis of estimated replacement costs. Its independent C.P.A.'s refused to accept the financial statement so prepared. U. S. Steel finally had to retract their position. The position of U. S. Steel is shared today by many businessmen and financial analysts. From some points of view, depreciation to a going concern is sometimes felt to be the provision of sufficient funds from current revenue to replace assets as they wear out. It is sometimes argued that, to the extent that depreciation allowances are based upon original cost rather than replacement costs, the income tax is actually taxing capital. The basic rationale is that income can exist only after a reasonable provision (in terms of current price levels and conditions) for maintaining the productive capacity of the organization. To the extent that depreciation is less than this, the income tax is actually acting to expropriate capital. ( 13, 202)

As alluded to above, basic accounting theory states that depreciation is not to cover replacement costs of capital assets--rather it is to provide for the protection of invested capital (original cost less salvage value.) It is true that some companies, some large ones, over-depreciate capital assets for purposes of their Profit and Loss Statements. This, in effect, reserves certain elements of profit for replacement at current or anticipated costs. However, for income tax purposes, this over-depreciation is written back on to the books.

Pechman summarized by saying there have always been provisions in the law for "a reasonable allowance for the exhaustion, wear and tear" of capital assets as a deduction for depreciation. Such deductions are necessary to avoid taxing capital rather than income. In addition, liberalized capital consumption allowances are proposed as devices to stimulate investment. (12, 124)

The annual deduction for depreciation is computed by spreading the cost of the depreciable asset over its estimated "service." Prior to 1954, the law and tax regulations were relatively strict, requiring fairly accurate estimates of the serviceable life of the asset. Original costs were amortized primarily by the "straight-line" method. This assumed a uniform amount of depreciation each year. The declining-balance method at 1.5 times the straight-line rate was permitted but seldom used. In 1954, the tax law was modified to allow the use of the declining-balance method with an annual rate twice the straight-line rate or the sum-of-the digits method.

Table VII shows the three methods for an asset originally costing \$1,000 and with an estimated service life of ten years. As will be noted, the straight-line method provides a uniform annual depreciation deduction of \$100 each year. The declining-balance method allows the taxpayer to utilize a rate of depreciation and to apply this rate to the undepreciated value each year. (12, 124) During the first year, the double declining-balance method provides a 20 percent depreciation allowance, leaving \$800 undepreciated. In the second year, the 20 percent is applied to \$800, providing an allowance of \$160, and etc. It might be mentioned that the taxpayer is permitted to switch to the straight-line method at any time. Under the sum-of-the digits method, the number of years till remaining are divided by the sum of years



in the useful life. With a ten-year asset, the sum of the years is 55 (10, plus 9, plus 8, plus..... .) (12, 124-125)

As illustrated by the Table VII, the two accelerated depreciation methods, concentrate a larger percentage of the deduction in the early years. Under the straight-line method, one-half the original cost of the asset is written off during the first five years--this is compared with 67 percent under the double-declining-balance method and 73 percent by way of the sum-of-the-years-digits procedure. Assuming a corporate income tax rate of 48 percent, the present value at the time of investment of the tax savings from the depreciation deductions amounts to \$353 under the straight-line method and \$384 under the sum-of-years-digits method. This assumes a 6 percent interest rate. ( 12, 125)

#### E. Accelerated Depreciation.

What is the advantage to the businessman to press for accelerated depreciation? If he obtains larger depreciation in the earlier years of the asset, will this not be offset by lesser deductions in later years and consequently, be increased tax liability? The great bonanza lies in the fact the taxpayer really is borrowing money from the United States Treasury at 0 percent. The following example may be used to illustrate this point:

A corporation would pay \$1 million a year in taxes over a ten-year period by using straight-line depreciation. If it is allowed to go to an accelerated base, which reduces the tax liability for the first five years to \$750,000 a year; for the second five years its tax will go to \$1,250,000 a year. Although the corporation will still pay a total of \$10 million in taxes over the ten-year period, it will have had the use of \$250,000 of taxes postponed for a five-year period. The Federal



Treasury has thus provided the corporation with working capital, or funds for construction or other purposes, at no interest. Accelerated depreciation was recognized in the tax law in 1954. Funds available for plant and equipment have grown correspondingly. In 1953, American industry (other than financial business) spent \$23.9 billion on new plant and equipment; its depreciation (and related amortization) allowance for that year was \$11.8 billion. In 1961, these same industries spent \$29.6 billion for new plant and equipment, but in view of accelerated allowance, they had available \$24.8 billion as the year's depreciation allowance. ( 6, 76-77)

The above can be interpreted as follows: In 1953 American non-financial business had available approximately one-half the cost of new plant and equipment from the year's depreciation, while in 1961 it was able to finance four-fifths of same. (6, 77-78)

#### F. Allowances for Depletion.

In 1926 provision was made in the Internal Revenue Code for a depletion allowance for the oil and gas industry. From 1926 to 1969 the rate was set at 27.5 percent. The Tax Reform Act of 1969 reduced this percentage to 22. The depletion allowance was limited to 50 percent of net income. The 1969 Act subjects "excess" depletion to the minimum tax. The oil and gas industries were permitted to treat exploration and development costs as deductible current expenses. ( 11, 31)

Revenue "Cost" according to Pechman amounts to \$1.2 billion per year. Senator Nelson estimated that by reducing the oil depletion allowance to 15 percent, an increase in revenue would be realized in 1973 of \$400 million. The treatment of intangible drilling and development costs as capital expenditure would yield \$750 million in 1973.

## SECTION III

## An Appraisal of The Investment Tax Credit

Although the foregoing passages discuss tax shelters in general terms, specific analysis requires that a particular type of shelter be isolated and viewed in more detail. This type of analysis needs to be conducted from the standpoint of what the specific tax preference does, what segments of the economy are effected, and the element of grant to the business world brought into play in each case. The investment tax credit is chosen for this discussion.

A. Legislative and Fiscal Background.

Preparatory to discussing a quantitative analysis of the investment tax credit, it would seem apropos to review the Tax Reduction Act of 1975, P.L. 94-12, (H.R. 2166). This review will not attempt to cover all facets of the legislation--just those areas pertaining to the investment tax credit and related subjects as necessary for analytical purposes.

Under the former law (the term former law applying to provisions in existence prior to the passing of P.L. 94-12) the investment credit applied to machinery and equipment placed in service but not to structures. The former credit allowed a deduction from tax liability amounting to 7 percent of the cost of investment--4 percent in the case of public utilities. This credit was in addition to depreciation (i.e., it did not change the basis for computing depreciation). The allowable credit could not exceed \$25,000 plus one-half of taxable income in excess of \$25,000. A 3-year carryback and a 5-year carry forward of unused investment credit were available. The amount of the investment that qualified for the credit depended on the useful life of the asset. Property with a useful life of



less than three years did not qualify. One-third of the cost of property with a useful life of three to five years was eligible for the credit--two-thirds of the cost of property with a useful life of five to seven years was eligible and the full cost of property having a useful life of seven years or more was eligible. There was a limit of \$50,000 on the amount of used property eligible for the credit. ( 17, 29)

The Administration proposal provided a temporary one-year increase in the credit to 12 percent for all property--this included public utility property. In addition, utilities were to continue to receive credit for investment in electrical power installations other than oil and gas-fired facilities. The credit was to be applicable to property placed in service in 1975 as well as that property ordered in 1975 if placed in operation prior to the close of 1976. In the case of utilities the one-half of taxable income limit was to be increased to 75 percent for 1975 and then to decline until it reached 50 percent again in 1980. The total impact on revenue was estimated to be \$4 billion.

So much for the Administration's proposal. When the bill reached the House, certain changes were made. It provided a temporary one-year increase in the credit to 10 percent for all types of property that would be placed in service after January 2, 1975 and prior to January 1, 1976. This included public utility property. It might be mentioned that, in the case of public utilities, the increased credit was limited to \$100 million for any one company. For public utilities the one-half of taxable income limit was to increase to 100 percent for 1975 and 1976 then decreased by ten percentage points each year until it reached 50 percent in 1981. The used property limitation was set at \$75,000 for one year.

The bill, as passed by the House, allowed a permanent change by



allowing an earlier investment credit for property requiring at least two years to construct. The taxpayer would be allowed to include in the base of the credit amounts expended (attributable to the taxable year) on the property during the construction period. This is versus waiting until the property was placed in service. Under the above-mentioned House version, the revenue loss was estimated at \$3.9 billion. Of this loss, \$1.5 billion was forecasted to occur in 1976.

It is interesting to compare the Administration proposal and H.R. 2166. Both proposals increased the investment tax credit--the Administration recommended a higher percentage increase. On thing common to both proposals was that they were designed to stimulate the economy by encouraging businesses to increase their capital investment in machinery and equipment. Both proposals increased the percentage allowance to public utilities equal to the rate allowed other businesses. It must be mentioned that H.R. 2166 set a limit on the credit for public utilities to \$100 million for a single company. As can be noticed from the above, there was no important difference in the revenue loss estimated by each proposal. ( 17, 29-31 )

The Treasury Department offered testimony to the Senate Finance Committee in which the Secretary of the Treasury supported the increase in the investment credit to 12 percent rather than 10 percent. The Secretary proposed that although the difference between 12 percent and 10 percent may seem small, the difference could result in a significant differential in the overall rate of return on investment.

The Senate Finance Committee compiled their own version of H.R. 2166. They increased the investment credit for all businesses to 12 percent for the period January 21, 1975 through December 31, 1976. This included

public utilities. The credit was to be subsequently set at 10 percent. Taxpayers who elected to procure the benefits of a 12 percent credit rather than 10 percent were required to utilize one-half of the additional benefit obtained (one-twelfth of the 12 percent credit) to fund an employee stock ownership plan. This was in case they could claim an investment tax credit for at least \$10 million of qualified property.

The credit increase was available to public utilities only if it were taken into account as a reduction in the utility's base for rate-making or cost of service ratably over the useful life of the property. The used property limitation was removed.

The revenue loss related to the Senate Finance Committee's version was estimated to be \$4.4 billion. The Senate adopted the Finance Committee's version of the proposed legislation. (17, 32-33)

In summary, P.L. 94-12 as passed by the Congress, provides a temporary two-year increase in the investment tax credit to 10 percent for all property. This includes public utility property. The requirements are that the property must be placed in service after January 21, 1975 and prior to January 1, 1977. A Corporation may choose to make an election whereby an 11 percent credit is available for the first year if an amount equal to 1 percent of qualified investment is contributed to an employee ownership plan.

No limitation exists on the dollar increase in the investment credit for a single utility. The House version of the bill contained a temporary increase in the 50 percent limitation for public utilities; this was retained as slightly modified by the Senate. The Senate version would accelerate the increase for fiscal-year taxpayers. As for the used property limitation the \$50,000 was increased to \$100,000 for two years.



Certain provision regarding property under construction as proposed in the House bill were retained. Under the bill as passed, the revenue loss is estimated to be \$3.3 billion for 1975. ( 17, 33)

#### B. Impact Upon Capital Investment.

MIT economist Lester C. Thurow, in his book The Impact of Taxes on the American Economy, shows that different taxes and expenditures have different impact multipliers. This makes it all the more important for Congressional and fiscal leaders to carefully analyze and examine quantitatively the impact of legislation such as the investment tax credit alluded to above. ( 15, 83-84)

The conceptual framework well suited for the analysis of all sorts of subsidies is grants economics. Sketching the ideas, as evolved during the past decade, co-authors Kenneth E. Boulding, Martin Pfaff, and Janos Horvath wrote:

"Qualitatively, the grants economy represents the heart of political economy, because it is precisely at the level of one-way transfers that the political system intervenes in the economic system. Quantitatively, a grant dollar tends to exert higher leverage on the economy than an exchange dollar thus positioning the grants economy to act as a regulator of the exchange economy. While the exchange economy operates by the rule of quid pro quo, the domain of grants economy performs such integrative functions as income redistribution, system maintenance, economic growth, technological advancement, and so on." (2, 21)

For purposes of the present study, grants economics appears useful in two contexts. Firstly, it illuminates certain problems of the productive capacity as a factor in the inflation-unemployment dilemma. Secondly, it provides the computational technique for identifying the subsidy (i.e., grant) equivalents embodied in tax shelters and related credits.



In search for a diagnosis of the inflation-unemployment dilemma, a novel solution is offered by Butler University economist Janos Horvath. He has stated that many seemingly minute changes evolving inside the American economy during the past four decades have reached a point where they alter important systematic relationships. The inflation-unemployment phenomenon of current years presents a dilemma largely because it is occurring within a national economy of changing structure. Conventional concepts of economic analysis that could be used to diagnose past problems do not now fully suffice. (8, 1) "The growing institutional entanglements of contemporary national economy have prompted a paradoxical framework wherein 'implicit grants' (transfers) accrue to privileged groups in compensation for the restraint of market supply. This amounts in microeconomics to the rewarding of non-achievement and in macroeconomics to the rewarding of negative-achievement." (8, 2) "The 'invisible hand' of the market system is held down by 'visible hands', to the ultimate detriment of the national economy." (8, 10) A central idea is that since implicit grants inspire and reinforce the present inflation-ridden unemployment, distinction should be made between "grants" which are counter-productive and those which do enhance and are conducive to optimal capacity utilization. (8, 2)

What is perceived here is the notion of misapplied grants. It is true that the precepts of Adam Smith were voiced in a by-gone day, surrounded by a different economic environment. Yet the question remains: have we become so sophisticated that we now think of the law of supply and demand as no longer relevant to today's economic problems? It must be admitted that our economic way of life is more complex than in former ages; however, is it still not important to insure industry the

capability of producing marketable goods unfettered by tax laws that fail to provide for the systematic replacement of necessary productive facilities in concert with present-day costs? Is not the investment tax credit a very important tool in the performance of this function, thereby alleviating, to some degree, certain of the problems alluded to earlier in this paper?

On the other hand, discretion must be used to make sure that efforts are not misdirected. Lester C. Thurow, in discussing priorities for tax policies, states that value judgments must be inserted into the various analyses if equitable public policy recommendations are to be made. (15, 153) If certain groups are receiving favorable tax treatment, the degree and ultimate economic impact of such favoritism should be known. The American political system receives low marks in the area of taxation. Instead of making social value judgments clear and explicit, deliberate efforts are made to hide special privileges. (15, 154)

The writer of present essay, on a day to day basis, contacts leading industrial organizations whose financial statements show them to be solvent; however, many of these same companies have cash flow problems. Why is this happening? The fact is, it is happening in spite of governmental controls and regulations that go ad infinitum. During recent decades much knowledge has accrued to this nation's stock of economic knowledge, yet to a large degree this expertise is ignored in favor of the varied whims, promises, and emotional tides generated by political parties and pressure groups seeking special privileges. The basic tenets necessary for good economic health are clear; however, such health cannot be achieved by conforming to every whim that would favor a special segment of the economy. A fine clock cannot give accurate

time if one or more of its gears are controlled. Lo, the controlling of one gear leads to the necessity of controlling another, then another, until the whole timepiece has lost its ability to perform automatically and accurately. So it is with a nation's economy.



## SECTION IV

## Impact Upon The Economy: A Quantitative Analysis

The following is an exploration of the above subject and its related effects upon the economy. In certain instances assumptions are made for purposes of explanation.

Recent pages have discussed various tax shelters with specific attention directed to the investment credit provision most recently amended by P.L. 94-12. Inquiry may be made as to what this tax provision actually accomplishes. In essence, the investment tax credit may be referred to as an element of transfer--a transfer payment from the public sector to the private sector. A grant is being made to industry via the tax structure.

Further inquiries may be made in the light of the above. First, what is the grant element? Secondly, what can this mean to the manufacturing industry? Lo, what can it mean to the private sector in total?

Just a cursory examination of the salient facts will lead to certain pertinent conclusions.

The Senate adopted the Finance Committee's version of the tax bill, which Congress voted into law as P.L. 94-12. At the time of the final testimonies and hearings it was estimated that the bill, as passed by Congress, would result in a revenue loss for 1975 of \$3.3 billion. (This amount is relative to the credit provision.) (17, 33) If this credit to industry is used to enlarge capital facilities in accordance with the Act, it must be concluded that, industry is getting the benefit of a 10 percent reduction in the cost of investment funds.

Although the cost of money has decreased in recent months, the past three to four years have spanned a period of high-cost borrowing. The prime rate of interest at The Chase Manhattan Bank in New York City increased from 5-3/4 percent as of December 31, 1971 to 11 percent at December 31, 1974. Since that time it has moved downward until it reached 7-1/2 percent at December 31, 1975. Early months of 1976 have shown some continued reduction; however, it cannot be said that the cost of borrowing is low.

As mentioned previously, prior to the Tax Reduction Act of 1975, P.L. 94-12, the investment credit allowed a deduction from tax liability equal to 7 percent of the cost of investment (4 percent in the case of public utilities). The credit was in addition to depreciation (i.e., it did not change the basis for computing depreciation). P.L. 94-12 provided a temporary two-year increase in the investment credit to 10 percent for all property (including public utility property) placed in service after January 21, 1975 and before January 1, 1977.

Although the following numerical values are relative, depending upon the tax liability of a company and its expenditures for capital, they are used here for explanatory purposes. If a company's tax liability is \$100,000 prior to the deduction of the investment credit, and as the result of purchasing \$100,000 worth of qualifying machinery and equipment such company takes the allowable credit, the net liability is reduced to \$90,000. Effectively, this means the credit has resulted in a grant of \$10,000 and for purposes of definition, a grant ratio of 10 percent relative to the gross tax liability. The expansion of this brief example to all industries on a nation-wide basis will give some insight as to the potential of this particular tax provision.

Before further examining the various aspects and alternatives associated with the investment credit, one might ask what has been accomplished by this tax provision. It is somewhat difficult to positively identify certain economic trends with the effectivity of the credit; however, it would seem that some conclusions can be reached based upon certain empirical data.

Chart II shows business expenditures for plant and equipment covering the years 1960 through 1975. A five-year average of expenditures increased from \$36.75 billions in 1960 to \$54.42 billions in 1965. This period, of course, spanned the original 7 percent investment credit enacted in 1962. From 1969, the year that the original Act was repealed, through 1970, expenditures increased from \$75.56 billions to \$79.71 billions--only \$4.15 billions; however, for the period 1971, the year of re-enactment of the credit through 1975, yearly expenditures increased from \$81.21 billions to \$116.08 billions, maintaining an average level of \$99.57 billions per year.

In spite of the above-mentioned increase in plant and equipment, the question might be asked as to how this investment was utilized. Table VIII covers the period 1950 through the first quarter of 1975. Using the year 1967 as an index of 100, all manufacturing capacity moved from 50 in 1950 to 161 as of March 31, 1975. Percentage of output to capacity never fell below 75, which was for the year 1971, except the first quarter of 1975 which showed a percentage utilization of 68. For all intents and purposes, this indicates that, in spite of an increase in capacity, utilization kept pace reasonably well. (16, 732)



A number of other factors appear to show positive correlation with the effectivity of the investment tax credit. These include, but are not limited to: capital appropriations and expenditures by large corporations; capital investment per worker; that portion of G.N.P. applicable to private investment; and reduction of the prime rate of interest. These are not examined in detail due to their broad expanse and the probability that various other conditions could have made effective contributions.

At this point, the question is asked--what other tax incentives could have been legislated that would produce as good or better overall economic advantages? The list is long and varied; however, enumerated below are a few examples:

1. Do nothing with the 7 percent credit as first established in 1962.
2. Decrease the credit.
3. Set the credit at some higher percentage point level.
4. Eliminate the credit altogether and instead, provide for the granting of concessionary loans to industry under certain qualifying conditions.

It would appear that the first and second of the above alternatives are self-defeating. The third alternative is omitted due to the fact it is closely related to the law as amended. The fourth would seem to offer more potential for exploration.

The objective of capital expansion can be achieved in various ways, some more beneficial than others; however, for purposes of exemplification a hypothetical situation is used. The assumptions and questions mentioned below will serve as parameters for the example.

1. The government seeks to encourage industry to increase capital investment.
2. The lending agency will strive to maintain the grant ratio at a maximum of 11 percent.
3. The financial vehicle considered for such a program is the concessionary loan, the contract terms of which are to be structured so that the above-mentioned grant ratio will not be exceeded. The following terms are used here as a basis for posing certain questions:
  - a. Time of maturity in years.....15
  - b. Moratorium period in years..... 1
  - c. Rate of interest..... 4.75%

As an entree to the discussion of the benefits of one investment incentive over another, or a trade-off of one against the other, the following inquiries may be made:

1. How much change in contract terms would be necessary to achieve the aforementioned goals? (This question is set forth with the knowledge that P.L. 94-12 contains an approximation of such a grant ratio.)
2. What are the implications of concessionary loans versus the investment tax credit? In other words--how much tax credit equates to how much concessionary loan?

As a first step of this analysis, it is necessary to determine the grant ratio inherent in the above-mentioned contract terms of payment. This can be done by the use of the appropriate formulae. Indeed, the concessionary loan is not a new device for the granting of aid to the various segments of the economy. A comprehensive methodology for calculating the grant equivalent has been developed by Butler University economist Janos Horvath. He also adapted the concept to international development lending (10), to export credits (9), to technology transfer (7), and to the inflation-unemployment problem (8).

$$(1) \quad G = L - \sum_{j=1}^T \left[ \frac{C_j + I_j}{(1 + q)^j} \right], \text{ Where:}$$

$G$ ---is the grant equivalent (subsidy) in cash terms;  
 $L$ ---is the face value of the loan;  
 $T$ ---is the time of maturity in years;  
 $q$ ---is the opportunity rate of discount;  
 $C_j$  and  $I_j$  are respectively the capital repayment  
 and interest payment due at the close of the  $j$ -th year.

$$(2) \quad g' = \left[ 1 - \frac{i}{q} \right] \left[ 1 - \frac{\frac{-qM}{e} - \frac{-qT}{e}}{q(T - M)} \right], \text{ Where:}$$

$g'$ ---is the grant ratio of the concessionary loan;  
 $M$ ---is the moratorium years on repayments, i.e., the  
 grace period.

$$(3) \quad g = \left[ 1 - \frac{i}{q} \right] \left[ 1 - \frac{\frac{-qM}{e} - \frac{-qT}{e}}{q(T - M)} \right] \pm g_1 \dots \pm g_n$$

$g$ ---is the total grant ratio;  
 $g_1 \dots g_n$ ---are the general statements for  
 additional grant components.



The aforementioned contract terms are repeated for purposes of the following formula:

g'-----is the grant ratio.  
 i -----is the interest rate of .0475.  
 q -----is the opportunity cost of .0675.  
 T -----is the period of the loan--namely--15 years.  
 M -----is the moratorium period of 1 year.

Therefore:

$$g' = \left[ 1 - \frac{-(.0675)(1)}{2.718} \right] \left[ 1 - \frac{-(.0675)(15)}{2.718} \right]$$

$$g' = .118$$

From the above computation, it can be stated that for every dollar loaned under the terms of contract, slightly over 11¢ constitutes an element of grant. Before discussing the advantages or disadvantages of concessionary loans versus the investment tax credit, there is a need to know what must be done to make such loans conform to the grant ratio of 11 percent. A prerequisite to this is a sensitivity analysis of the concessionary terms of the contract. Such an analysis can be made by using one of the independent variables.

$$S_g^T = \frac{\partial g}{\partial T}$$

(9, III)

The above represents the absolute sensitivity of grant ratio with respect to the time period of the loan. Other variables can be substituted for purposes of analysis.

Further, the relative sensitivity of the grant ratio with respect to the various contract terms can be determined by the following:

$$RS_T = \frac{\frac{\partial S}{\partial T}}{\sum_j \frac{\partial S}{\partial j}}, \text{ where } j \text{ is the general notation for the variable, i.e., } T, M, i, \text{ etc.}$$

(9, III)

By use of the above methodology the following data may be computed for purposes of analysis:

| <u>Concessionary Loan</u>          |                             |                    |                    |                 |
|------------------------------------|-----------------------------|--------------------|--------------------|-----------------|
| <u>Concessionary Factors</u>       | <u>Contract Terms Given</u> | <u>Grant Ratio</u> | <u>Sensitivity</u> |                 |
|                                    |                             |                    | <u>Absolute</u>    | <u>Relative</u> |
| Time of maturity--years.           | 15                          |                    | 0.0052             | 0.0726          |
| Moratorium--years (Grace).         | 1                           |                    | 0.0073             | 0.1020          |
| Rate of interest.                  | 4.75%                       |                    | -0.0591            | 0.8254          |
| Discount rate as opportunity cost. | 6.75%                       |                    |                    |                 |
| Grant ratio of loan.               |                             | .118               |                    |                 |
| Totals--sensitivity.               |                             |                    | 0.0716             | 1.0000          |

The above-mentioned absolute sensitivity gives the "percentage point" change in the grant ratio when the contract term is changed by a certain amount. The relative sensitivity shows the relative weighting, or contribution, of the contract term toward the grant ratio. (9, 110-111)

From the above data certain basic information can be made available from which comparisons may be made. If it is desired to encourage the expansion of private capital by the use of concessionary loans--since the grant ratio is highly sensitive to change in the rate of interest--it would seem that this contract term should be modified to effect the aforementioned requirement.

The above may be used as a tool by policy makers in arriving at the best possible methods for boosting certain sectors within the overall economic structure, or inversely, slowing down certain areas that might be contributing to conditions detrimental to the economy.

From the above example, the sensitivity of the grant ratio with respect to a change in the rate of interest is equal to 0.0591. If, for example, it is desired to reach a grant ratio of 11 percent, the desired decrease of 0.0080 ( $0.1180 - 0.1100$ ) can be reached by increasing the interest rate from 4.75 to 4.89 percent ( $0.0080/0.0591 = .1354$  and  $4.75 \text{ percent} + .1354 = 4.89 \text{ percent}$ ). This result can be verified by substituting the revised rate in the aforementioned formula which, with all other factors remaining constant, will result in a grant ratio of 11 percent. Other contract terms may be changed in like manner by the use of the sensitivity analysis.

What does the above mean in terms of real-life investment practices? Suppose a business wishes to purchase machinery and equipment costing \$500,000; if the transaction qualifies under the investment tax provision, the amount of grant involved is \$55,000 and the grant ratio is 11 percent. In this particular case, the tax loss to the government would be \$55,000. If, on the other hand, the business is not afforded the opportunity of a tax credit but can apply for a concessionary loan with contract terms of the aforementioned example, the grant ratio is 11.8 percent. By increasing the rate of interest from 4.75 percent to 4.89 percent, as mentioned in the preceding paragraph, the grant ratio is equal to that of the investment tax credit.

Further, if the interest rate in the preceding example is raised from 4.75 to 5.75 percent, with all other contract terms remaining constant,



The grant ratio is reduced to 5.91 percent. When applying this to the purchase of machinery and equipment costing \$500,000, the result is a decrease in grant of \$25,450 (\$55,000 less \$29,550). A one percentage point increase in the rate of interest exemplifies the high sensitivity of the interest rate to the change. Again, holding all other factors constant, the raising of the rate of interest by two percentage points would completely eliminate the grant.

An incentive can be given to business for the expansion of machinery and equipment by either a tax credit or by a concessionary loan. Each plan has its advantages and disadvantages. Based on the experience of this writer, a businessman would be more likely to use dollars saved from taxes to further expand his productive facilities than to burden himself with a ponderous repayment program including not only principal but interest.

Finally, in consideration of the whole economic scheme of things inherent within the free-enterprise system, is not incentive a major force? In consideration of certain principles alluded to earlier, is not the investment tax credit a type of incentive that will not only generate but regenerate those forces that maintain the momentum of the total economy and at the same time minimize the burden on business? It would seem that the answer would be in the affirmative.

## SECTION V

## Conclusion

The foregoing pages have alluded to the subject of taxes from the standpoints of general history, growth and incidence. Tax shelters have been discussed as to the general types most commonly referred to and used. A specific tax shelter, namely the investment credit, has been discussed in some detail. Lastly, this particular tax shelter has been viewed from the standpoint of the grant (i.e., transfer payment contained therein) by the methodology of quantitative analysis.

It now seems necessary to view the subject of this paper in the light of all that has been discussed. The question--Tax Shelters: Economic Stimuli Or Media Of Inequality--must be answered in a manner that is meaningful in the context of our present economic environment. Literally hundreds of volumes, pamphlets, studies, analyses, hearings, and testimonies have been written and conducted relative to this particular portion of our tax structure. After all of these efforts, it appears to the writer that a tax shelter can be either an economic stimuli or a medium of inequality, depending upon its provisions and its application.

At this stage of our economic growth, we do not live wholly within a laissez-faire environment as depicted by Adam Smith and advocated nowadays by Milton Friedman. Neither do we live completely within the realm of corporate giantism and planning as proposed by polemic economics of John Kenneth Galbraith. Rather, we are faced with problems, the solutions to which are best approached through the analysis of balance between exchange and grants economics, as perceived by Kenneth E. Boulding and his school. Society is best served, and it in turn can serve

humanity better by functioning within an economic environment characterized by allocative efficiency joined with distributive equity.

If there must be grants from the public to the private sector, and from all past and present indications there must be, then let these transfer payments be made in such a manner and directed to such goals that will stimulate the economy yet maintain and enhance our free-enterprise system. This is not to say that exchange economics is to be thrown out of the window completely—it is merely saying that a pure system of exchange economics will not come to grips with the pressing problems of this day. ( 2, 1)

As alluded to numerous times before, the investment tax credit, if properly administered, can lead to industrial growth and continued economic health. There is, however, another important point that must be made at this time. This provision for the increase of production of consumptive goods must not be shackled by irrelevant, mis-guided, and multitudinous legislation, regulation and executive edict that will restrict the production of supply, or the consumption of such production.

It is obvious to the most casual observer that inflation and under-employment are two of the most devastating forces in our economic system. If legislation is directed toward the optimization of efforts that will more fully utilize our productive capacity, rather than the restriction of such efforts, a higher level of economic health can be achieved for all people. If, on the other hand, society takes the path of least resistance, there could be further erosion of our economic well-being.

It is the writer's opinion that the former must prevail.



TABLE I  
Proceeds Of The Civil War Income Tax \*

|  | Total            |
|--|------------------|
| Income from \$600 to \$10,000 . . . . .              | \$ 17,814,170.82 |
| Income over \$10,000 . . . . .                       | 16,494,961.48    |
| Income from property of citizens residing abroad . . | 230,470.79       |
| Income from interest on U. S. securities . . . . .   | 212,413.84       |
| Income from \$600 to \$5,000 . . . . .               | 58,078,597.20    |
| Income over \$5,000 . . . . .                        | 60,851,011.17    |
| Income over \$1,000 . . . . .                        | 94,848,692.44    |
| Income over \$2,000 . . . . .                        | 16,097,921.33    |
| Income from bank dividends . . . . .                 | 27,854,024.01    |
| Income from bank profits . . . . .                   | 1,279,690.42     |
| Income from canal companies' dividends . . . . .     | 1,785,812.11     |
| Income from insurance companies' dividends . . . . . | 5,689,070.15     |
| Income from railroad companies' dividends . . . . .  | 21,416,738.53    |
| Income from railroad companies' interest on bonds .  | 9,987,844.63     |
| Income from turnpike companies' dividends . . . . .  | 237,324.76       |
| Income from salaries of U.S. officers & employees .  | 14,029,994.88    |
| TOTAL . . . . .                                      | \$346,908,738.56 |
| Special income Tax . . . . .                         | 29,381,862.00    |
| GRAND TOTAL . . . . .                                | \$376,290,600.56 |

\* Compiled from tables in the Annual Report of the Commissioner of Internal Revenue for the year 1872, and *ibid*, 1877.

Source: Seligman, Edwin R. A., The Income Tax, New York, N. Y., The MacMillan Company, 1914, p. 481.

TABLE II

Shares of the Federal Individual Income Tax  
By Major Income Brackets, 1970

| <u>Adjusted Gross<br/>Income Bracket</u> | <u>Share of Adjusted<br/>Gross Income</u> | <u>Share of<br/>Tax Liability</u> |
|--|---|-----------------------------------|
| Under \$7,000                            | 19.5%                                     | 10.5%                             |
| \$7,000 to \$19,999                      | 59.2%                                     | 54.0%                             |
| \$20,000 and over                        | 21.3%                                     | 35.5%                             |
| <u>Totals</u>                            | <u>100.0%</u>                             | <u>100.0%</u>                     |

Note: Compiled by Internal Revenue Service and cited as Statistics of  
Income, 1970.

Source: Freeman, Roger A., Tax Loopholes, Washington, D.C., American  
Enterprise Institute for Public Policy Research, 1974, p. 21.

TABLE III

Distribution of the Corporate Income Tax Burden on Individuals

| Adjusted<br>Gross<br>Income<br>Class | Full Forward<br>Shift to<br>Consumer<br>Prices | 3/4 Borne<br>by Consumer.<br>1/4 Borne<br>by Share-<br>holder | 1/2 Borne<br>by Consumer.<br>1/2 Borne<br>by Share-<br>holder | 1/4 Borne<br>by Consumer.<br>3/4 Borne<br>by Share-<br>holder | Full<br>Burden<br>on<br>Share-<br>holder |
|--------------------------------------|--|---|---|---|--|
| (\$000)-----(\$ billions)-----       |  |   |   |   |  |
| 0-3                                  | 2.8  | 2.8   | 2.8   | 2.7   | 2.7                                      |
| 3-5                                  | 2.4  | 2.1   | 1.8   | 1.6   | 1.3                                      |
| 5-7                                  | 2.9  | 2.4   | 2.0   | 1.5   | 1.0                                      |
| 7-10                                 | 5.4  | 4.5   | 3.6   | 2.6   | 1.7                                      |
| 10-15                                | 7.5  | 6.3   | 5.2   | 4.0   | 2.8                                      |
| 15-20                                | 4.0  | 3.5   | 3.0   | 2.5   | 2.0                                      |
| 20-50                                | 3.3  | 4.3   | 5.3   | 6.3   | 7.3                                      |
| 50-100                               | 0.7  | 1.7   | 2.6   | 3.6   | 4.6                                      |
| 100-up                               | 0.5  | 1.9   | 3.4   | 4.9   | 6.4                                      |
| Totals                               | 29.6   | 29.6  | 29.6  | 29.6  | 29.6                                     |

Note: Net liability at calendar year 1971 levels after all credits.

Source: National Association of Manufacturers, Committee on Taxation, Wealth, Taxation and Fiscal Policy, A Position Paper, 1972, p.16.



TABLE IV

Combined Effect of Changes in Tax Laws and Regulations Since  
January 1, 1969 on Corporations and Individuals\*  
(In Billions of Dollars)

|  | 1969-1980 ** |        |          |                    |
|--|--------------|--------|----------|--------------------|
|  | 1969-72      | 1972   | 12 years | Average<br>1 year. |
| Corporate Income Taxes                           | +\$4.9       | -\$0.4 | -\$ 8.1  | -\$0.7             |
| Individual Income Taxes                          | -18.9        | -12.0  | -140.7   | -11.7              |
| Excise Taxes--Primarily<br>Affecting Individuals | - 3.5        | - 2.6  | - 19.7   | - 1.6              |

Note: \*Treasury estimates, see Cohen, E.S., op.cit., April 1972.  
\*\*Assuming economic growth.

Source: National Association of Manufacturers, Committee on Taxation,  
Wealth, Taxation and Fiscal Policy, A Position Paper, 1972, p.19.

TABLE V

Effective Corporate Income Tax Rates  
Total Tax Paid and Tax Less Temporary Surcharge, 1969--All  
Corporations and Those With Assets of \$250 Million or More

| Returns of All           |              |                       |                         |                       |
|--------------------------|--------------|-----------------------|-------------------------|-----------------------|
| Active Corporations      |              |                       | Returns With Net Income |                       |
| Asset Size               | Rates        |                       | Rates                   |                       |
|                          | Total<br>Tax | Tax Less<br>Surcharge | Total<br>Tax            | Tax Less<br>Surcharge |
| \$250 Million<br>or More | 45.0         | 40.7                  | 43.3                    | 39.2                  |
| All Corpora-<br>tions    | 46.6         | 42.3                  | 40.0                    | 36.4                  |

Note: Effective rates in the above table reflect tax liability after deducting the investment credit but before the foreign tax credit, divided by net income.

Source: National Association of Manufacturers, Committee on Taxation, Wealth, Taxation and Fiscal Policy, A Position Paper, 1972, Corporate Income Tax Returns, 1969 Preliminary, p.20.

TABLE VI

Cost Recovery Allowances for Machinery and Equipment in  
Leading Industrial Countries

|  | Representative<br>Cost Recovery<br>Period<br>in<br>Years | Aggregate Cost Recovery Allowance:<br>Percentage of Cost of Asset |                            |                            |
|--|--|---|----------------------------|----------------------------|
|  |  | First Tax-<br>able Year   | First 3 tax-<br>able Years | First 7 Tax-<br>able Years |
| Belgium  | 10   | 20.0  | 48.8                       | 89.0                       |
| Canada   | 10   | 20.0  | 48.8                       | 79.0                       |
| France   | 8  | 31.3  | 67.5                       | 94.9                       |
| Italy  | 6  | 20.0  | 65.0                       | 100.0                      |
| Japan  | 11   | 34.5  | 56.9                       | 81.4                       |
| Luxembourg   | 10   | 28.0  | 60.4                       | 101.9                      |
| Netherlands  | 5  | 10.0  | 42.4                       | 77.1                       |
| Sweden   | 5  | 30.0  | 65.7                       | 100.0                      |
| Switzerland  | 6-2/3  | 15.0  | 58.4                       | 90.0                       |
| United Kingdom*  | 12   | 57.8  | 78.1                       | 102.1                      |
| Western Germany  | 9  | 16.7  | 49.6                       | 88.8                       |
| <hr/>  |  |   |                            |                            |
| Average percentage of<br>above countries                             |  | 25.7  | 58.3                       | 91.3                       |
| <hr/>  |  |   |                            |                            |
| U.S. With Asset<br>Depreciation Range<br>and 7% Investment<br>Credit | 10-1/2   | 28.3  | 57.8                       | 90.5                       |

\*

Note: Does not reflect changes in United Kingdom after October, 1970.

Source: Report of the President's Task Force on Business Taxation and U. S. Department of Treasury, 1971 estimates.



TABLE VII  
Comparative Depreciation Schedule: \$1,000 Asset

| (In dollars.)                                   |                      | Depreciation                    |                            |
|---|----------------------|---------------------------------|----------------------------|
| <u>Year</u>                                     | <u>Straight-Line</u> | <u>Double Declining-Balance</u> | <u>Sum-of-Years-Digits</u> |
| 1   | 100                  | 200                             | 182                        |
| 2   | 100                  | 160                             | 164                        |
| 3   | 100                  | 128                             | 145                        |
| 4   | 100                  | 102                             | 127                        |
| 5   | 100                  | 82                              | 109                        |
| 6   | 100                  | 66                              | 91                         |
| 7   | 100                  | 65.5                            | 73                         |
| 8   | 100                  | 65.5                            | 55                         |
| 9   | 100                  | 65.5                            | 36                         |
| 10  | <u>100</u>           | <u>65.5</u>                     | <u>18</u>                  |
| Totals  | 1,000                | 1,000                           | 1,000                      |
| Present value of 6%:<br>Depreciation Allowances | 736                  | 787                             | 800                        |
| Tax value of<br>Depreciation Allowances*        | 353                  | 378                             | 384                        |

Note: \*At a tax rate of 48 percent.

Source: Pechman, Joseph A., Federal Tax Policy, Washington, D.C., The Brookings Institution, 1971, p.125.

TABLE VIII

Index of Manufacturing Capacity and Relation of Output to  
Capacity: 1950 to 1975

| Year                      | Index of<br>Capacity | Relation of Output to Capacity (percent) |                       |                        |
|---------------------------|----------------------|--|-----------------------|------------------------|
|                           |                      | All Manufacturing                        | Primary<br>Processing | Advanced<br>Processing |
| 1950                      | 50                   | 92                                       | 98                    | 89                     |
| 1955                      | 64                   | 90                                       | 94                    | 88                     |
| 1960                      | 79                   | 80                                       | 79                    | 80                     |
| 1965                      | 100                  | 89                                       | 91                    | 88                     |
| 1968                      | 121                  | 88                                       | 87                    | 88                     |
| 1969                      | 128                  | 87                                       | 89                    | 85                     |
| 1970                      | 135                  | 78                                       | 82                    | 76                     |
| 1971                      | 140                  | 75                                       | 79                    | 73                     |
| 1972                      | 145                  | 79                                       | 85                    | 75                     |
| 1973                      | 151                  | 83                                       | 90                    | 79                     |
| 1974-prel.                | 157                  | 79                                       | 84                    | 76                     |
| 1975, 1st<br>qtr<br>prel. | 161                  | 68                                       | 69                    | 68                     |

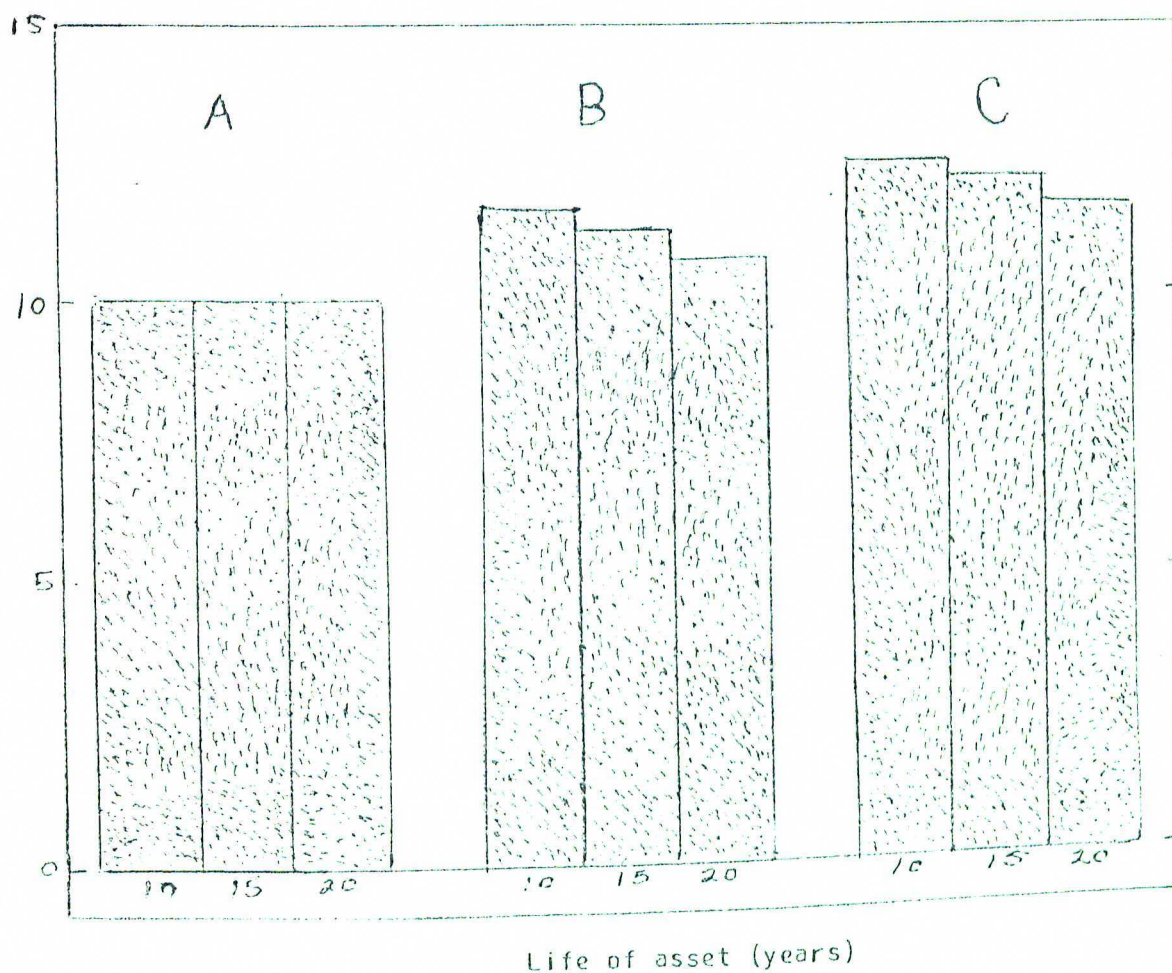
Note: 1967 output=100. Annual figures are averages of quarterly data.

Source: Board of Governors of the Federal Reserve System, Federal Reserve Bulletin, July 1967, and Capacity Utilization in Manufacturing (E.5.), quarterly, U. S. Bureau of the Census, Statistical Abstract of the United States: 1975, p. 732.

CHART I

Effect of 7 Percent Investment Credit and Double Declining-Balance Depreciation on Rate of Return of Ten-, Fifteen-, and Twenty-Year Assets Yielding 10 Percent With Straight-Line Depreciation.\*

Rate of return (percent)



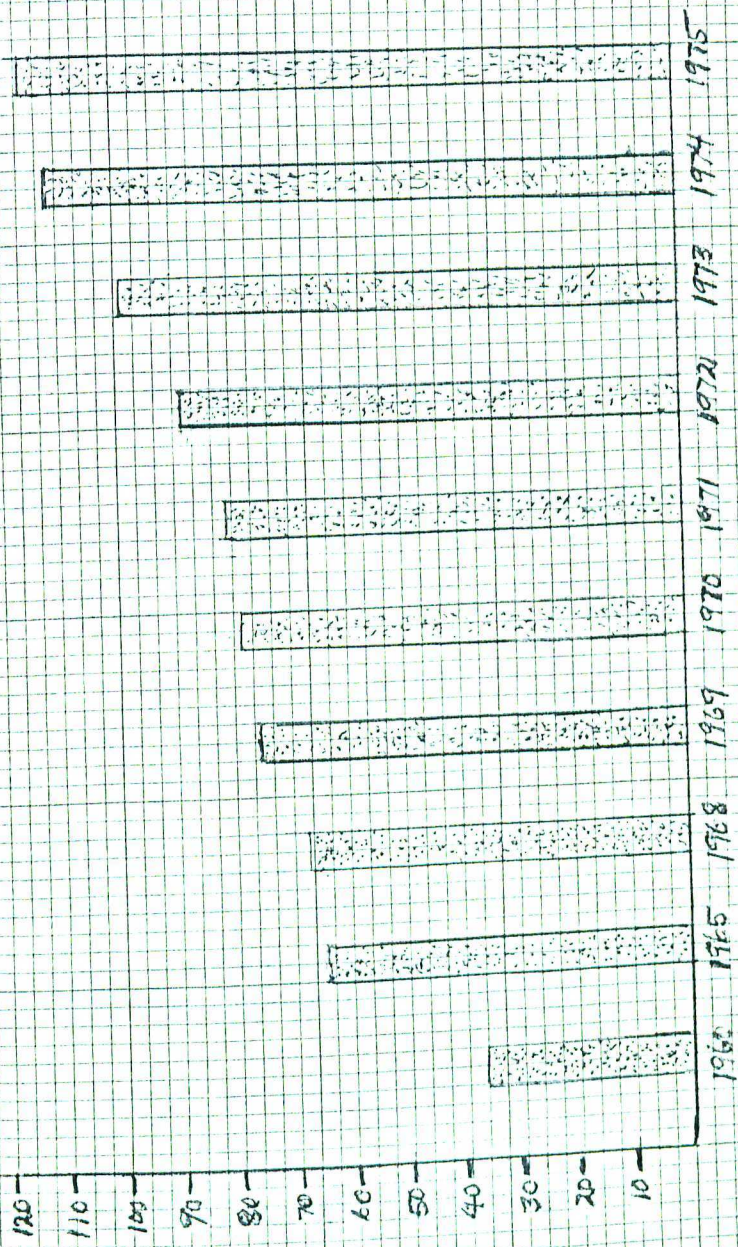
Note: \*Assuming a constant stream of annual receipts during life of asset.  
 A=Straight-line depreciation.  
 B=Straight-line depreciation plus 7 percent investment credit.  
 C=Double-declining-balance depreciation plus 7 percent investment credit.

Source: Pechman, Joseph A., Federal Tax Policy, Washington, D.C., The Brookings Institution, 1971, p.129.



CHART II  
Business Expenditures for Plant and Equipment—All Industries  
1960 through 1975

Billions of Dollars



Source: (Statistical Abstract of U.S., 1975, 811)



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